DIRECT GENERAL CORP
Form 424B4
March 24, 2004

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Registration No. 333-113289

PROSPECTUS

3,314,015 Shares

Direct General Corporation

Common Stock

The selling shareholders are selling all of the shares of common stock in this offering other than the shares subject to the over-allotment option described below. We will not receive any of the proceeds for shares sold by the selling shareholders.

Our common stock is traded on the Nasdaq National Market under the symbol DRCT. On March 22, 2004, the last quoted price of our common stock as reported by the Nasdaq National Market was $34.55 per share.

Investing in our common stock involves risks. See Risk Factors beginning on page 8.

	Per Share	Total
Public offering price of common stock	$ 34.250	$ 113,505,014
Underwriting discount	$ 1.627	$ 5,391,903
Proceeds (before expenses) to the selling shareholders	$ 32.623	$ 108,113,111

The underwriters may also purchase up to an additional 497,102 shares of common stock from us at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus to cover over-allotments. If the underwriters exercise that option in full, the total public offering price for the over-allotment shares, the underwriting discount related to these shares and proceeds to us would be $17,025,744, $808,785 and $16,216,959, respectively. The total public offering price and underwriting discount for the total offering, including the 3,314,015 shares offered by selling shareholders and the 497,102 over-allotment shares, would be $130,530,758 and $6,200,688, respectively.

Neither the Securities and Exchange Commission nor any state securities commission or regulatory authority has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the shares of common stock to purchasers on or about March 29, 2004.

Keefe, Bruyette & Woods

Morgan Keegan & Company, Inc.

SunTrust Robinson Humphrey

The date of this prospectus is March 23, 2004.

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You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information in this document may only be accurate on the date of this document.

Expanding Market Presence

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PROSPECTUS SUMMARY

This summary highlights information about Direct General Corporation and its subsidiaries and the common stock offering contained elsewhere in this prospectus. Because this is a summary, it may not contain all the information you should consider before investing in our common stock. To understand this offering fully, you should read this entire prospectus carefully, including the Risk Factors section and our consolidated financial statements and the accompanying notes included in this prospectus. We reference non-GAAP financial measures in this summary and elsewhere in this prospectus. An explanation of our reasons for using these measures and a reconciliation to the most directly comparable GAAP measures can be found under Management s Discussion and Analysis of Financial Condition and Results of Operations Measurement of Results Overview of Operating Results . Except as otherwise indicated, references in this prospectus to Direct , Direct General , the company , we , our , and us are to Direct General Corporation (including its subsidiaries) and references to Direct General Corporation are solely to Direct General Corporation, and, in each case, do not include the underwriters or selling shareholders. Except as otherwise indicated, all share figures in this prospectus assume that the underwriters do not exercise their option to purchase additional shares in this offering.

Direct General Corporation

Who We Are

We are a rapidly growing provider of non-standard personal automobile insurance, premium finance and other insurance and non-insurance products and services. Our operations are concentrated in the southeastern part of the United States. From 1999 to 2003, our total revenues grew from $139.4 million to $317.1 million and our gross revenues grew from $204.3 million to $523.8 million, representing a compounded annual growth rate of 22.8% and 26.5%, respectively. Net income over this same period increased from $7.6 million in 1999 to $43.1 million in 2003.

Our Business Model

We believe that our success is due primarily to the strength of our business model, which integrates the operations of our insurance, premium finance and agency subsidiaries. Our model also emphasizes the distribution of our products and services through neighborhood sales offices staffed by employee-agents as opposed to commissioned agents. Our business model allows us to generate significant revenues from sources other than premiums from the sale of our core product, non-standard personal automobile insurance policies, compared to the independent agency distribution model relied upon by many of our insurance competitors. These additional revenues include premium finance revenues, commissions from the sale of non-core insurance products and other revenues. Currently, none of these revenues entails insurance underwriting risk, and we believe most, if not all, of these revenues typically would be paid, in the independent agency distribution model, to an unaffiliated premium finance company, independent agent or other third party. These additional revenues totaled $49.4 million in 2001, $62.9 million in 2002 and $78.5 million in 2003, which represented 31.9%, 29.5% and 24.8% of our total revenues and equaled 80.3%, 95.4% and 97.0% of our total operating expenses for 2001, 2002 and 2003, respectively. We believe that our ability to produce these additional revenues from sources other than sales of our core product is a substantial competitive advantage.

As of December 31, 2003, we distributed our products and services through more than 325 neighborhood sales offices that are staffed by our employee-agents, including 42 offices in Florida that we acquired on November 1, 2003 by exercising our option to purchase the assets of an independent insurance agency network that had been producing business for us since 1999. In the first ten months of 2003 preceding the acquisition, this independent agency produced gross premiums written for us of approximately $86.7 million. Since our inception, we have grown our business through the acquisition of independent insurance agencies and the opening of new sales offices, and we intend to continue to employ these strategies for growth.

In January 2003, we began our expansion into Texas through an independent insurance agency network that we have an option to purchase in December 2004. If we exercise this option, the purchase price will be

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equal to the sum of a percentage of the premiums produced for our insurance subsidiaries and a reduced percentage for premiums produced for other insurers. Our option grants us the right to acquire the rights to service the customers of the agency and to acquire other assets used in the agency s operations. For the year ended December 31, 2003, our independent agencies produced $112.5 million of gross premiums for us, including $86.7 million through the acquired Florida agency before we purchased its offices and $15.6 million through the Texas agency network.

Our neighborhood sales offices serve as a channel for both product delivery and payment collection. Our widespread and convenient local presence appeals to our customers, most of whom prefer to conduct business face to face rather than by telephone or on the Internet. All policy applications are completed in the neighborhood sales offices, and most of our customers revisit these offices at least monthly to make their periodic payments.

We seek to attract customers by developing strong brand name recognition in our markets through our low-cost television advertising campaigns that emphasize our low down payments, flexible payment plans, convenient neighborhood locations and customer service. Our television advertising campaigns are designed to generate telephone inquiries to our neighborhood sales offices or to our centralized call center where indications of estimated premiums are given and prospective customers are directed to the nearest neighborhood sales office.

Our Products and Services

Our core business involves issuing non-standard personal automobile insurance policies. These policies, which generally are issued for the minimum limits of coverage required by state laws, provide coverage to drivers who cannot obtain insurance from standard carriers due to a variety of factors, including the lack of flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle. In general, customers in the non-standard market pay higher average premiums than customers who qualify for the standard market for a comparable amount of coverage. The higher average premiums compared to the standard market generally result from an increased frequency of losses, which is partially offset by the lower severity of losses resulting from lower limits of coverage.

Through our premium finance subsidiary, we finance almost all of the insurance policies that we sell. For the year ended December 31, 2003, we financed the premiums on 94% of the insurance policies produced through our distribution system. Premium finance involves making a loan to the customer that is backed by the unearned portion of the insurance premiums being financed. We structure our payment plans and integrate our systems in an attempt to minimize the risk of principal losses on our premium finance loans. We offer our customers a variety of flexible payment plans that allow for low down payments, which we believe is a significant factor our customers consider when purchasing insurance.

We offer a variety of other insurance products designed to appeal to purchasers of our non-standard personal automobile insurance policies, including term life insurance currently offered through one of our wholly-owned life insurance subsidiaries, as well as vehicle protection insurance, travel protection insurance and hospital indemnity insurance underwritten by unaffiliated insurers for which we receive a commission but do not bear insurance underwriting risk. We are exploring the possibility of offering additional insurance products, such as renters , homeowners (including mobile homeowners), motorcycle, boat and personal watercraft policies. These additional insurance products may either be underwritten by unaffiliated insurers, from which we would receive a commission, or underwritten by us, with the majority of the underwriting risk expected to be ceded to unaffiliated reinsurers from which we would receive a ceding commission.

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Our Strategy

Our goal is to generate a superior return to our shareholders. To achieve this goal, we have developed a strategy that seeks to capitalize on our strengths. Key aspects of our strategy include:

- Maintaining a local market presence and strong brand awareness in the markets we serve;
- Distributing our products and services through a broad network of neighborhood sales offices that emphasize the use of salaried employees and a largely fixed cost of distribution;
- Leveraging our integrated business model to capture significant additional revenues from premium financing, term life insurance premiums and commissions, and defraying a large portion of our operating expenses with these additional revenues;
- Using our distribution system to increase sales of our non-core insurance and non-insurance products and services, including expanded offerings of these products and services;
- Expanding our distribution network through acquisitions of local agencies and the opening of new sales offices; and
- Controlling costs through our in-house claims management and disciplined policy underwriting and pricing.

Certain Risks We Face

Our efforts to capitalize on our strengths and successfully implement our strategy entail risks. For example:

- Because our core product is non-standard personal automobile insurance, negative developments in this industry could adversely affect us to a greater extent than more diversified insurers that also sell other types of automobile insurance products;
- Adverse developments and cyclical changes in the personal automobile insurance market could cause our results to suffer;
- The concentration of our business in Florida and Tennessee make us more susceptible to any negative developments in the prevailing regulatory, economic, competitive, or other conditions in these states, and could make it more costly or difficult for us to conduct our business;
- The success of our growth plan, which includes expanding into new states by acquiring the business and assets of local agencies, depends upon our ability to identify agency acquisition candidates and, when acquired, integrating their operations;
- Because of our largely fixed cost structure, a decline in sales volume could, among other things, decrease our profitability;
- Implementation of our growth plan requires that we continue to strengthen our capitalization or continue to use reinsurance to meet our regulatory capital and surplus requirements, which could leave us vulnerable to a failure by our reinsurers to pay amounts due to us;
- Our status as a holding company makes us dependent upon the ability of our operating subsidiaries to pay dividends to us, and state insurance laws limit such payments and require our insurance subsidiaries to maintain specified minimum levels of statutory capital and surplus; and
- The current ratings of our insurance subsidiaries or any failure of our insurance subsidiaries to maintain their current ratings could result in increased interest rates or reinsurance costs to us. Three of our property and casualty insurance subsidiaries are currently assigned a rating of B (Fair) and the remaining property and casualty insurance subsidiary is currently assigned a rating of B- (Fair) by A.M. Best Company, Inc. B (Fair) and B- (Fair) are the seventh and eighth highest ratings, respectively, out of 15 available ratings.

For further discussion of these and other risks we face, see Risk Factors.

Recent Development

On January 30, 2004, we acquired an inactive life insurance company for a purchase price of $7.3 million. The assets of this life insurance company consist primarily of: (i) licenses to conduct life and accident and health insurance business in 43 states and the District of Columbia and (ii) cash and debt securities with an aggregate market value of approximately $6 million. We acquired licenses to sell our life insurance product in North Carolina, and in Texas, where we are currently expanding, and in Missouri and Virginia where we intend to expand in the future. We plan to start offering our term life insurance policies in North Carolina through this newly-acquired life insurance company during 2004.

How to Contact Us

Our headquarters are located at 1281 Murfreesboro Road, Nashville, Tennessee 37217. Our telephone number is (615) 399-0600.

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The Offering

Common Stock Offered by Selling Shareholders	3,314,015 shares
Common Stock Outstanding After This Offering(1)	21,657,655 shares
Use of Proceeds	We will not receive any of the proceeds from the sale of shares of our common stock offered by the selling shareholders. Proceeds from the sale of shares, if any, upon the exercise of the underwriters over-allotment option are expected to be used to contribute additional capital to our insurance subsidiaries and for general corporate purposes.
Nasdaq National Market Symbol	DRCT
Dividend Policy	We declared a quarterly dividend of $0.04 per common share on November 7, 2003 for shareholders of record on December 1, 2003, and the dividend was paid on December 15, 2003. We declared a quarterly dividend of $0.04 per common share on February 25, 2004 for shareholders of record on March 1, 2004, and the dividend was paid on March 15, 2004. We presently anticipate continuing the payment of quarterly cash dividends. The declaration and payment of dividends is subject to the discretion of our board of directors and will be subject to significant restrictions, which are described under Dividend Policy , Business Regulatory Environment and elsewhere in this prospectus.

(1) Based on the number of shares of common stock outstanding on March 23, 2004 and excludes 366,989 shares subject to outstanding options under our 1996 Employee Stock Incentive Plan, 986,000 shares subject to outstanding options under our 2003 Equity Incentive Plan and 694,000 shares available for future grants under our 2003 Equity Incentive Plan. See Management 1996 Employee Stock Incentive Plan and Management 2003 Equity Incentive Plan .

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Summary Historical Consolidated Financial and Operating Data

The following tables provide a summary of historical consolidated financial and operating data of Direct General as of the dates and for the periods indicated. In conjunction with this summary and in order to more fully understand our historical consolidated financial and operating data, you should also read Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the accompanying notes included in this prospectus. We derived our summary historical consolidated financial data as of December 31, 2003 and 2002 and for the years ended December 31, 2003, 2002 and 2001 from our audited consolidated financial statements included in this prospectus. We derived our summary historical consolidated financial data as of December 31, 2001, 2000 and 1999 and for the years ended December 31, 2000 and 1999 from our audited consolidated financial statements not included in this prospectus. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions, except per share data)				
Statement of Operations Data:					
Premiums earned	$ 228.5	$ 145.0	$ 98.0	$ 73.9	$ 91.6
Finance income	44.9	35.7	27.3	24.6	21.6
Commission and service fee income	33.6	27.2	22.1	21.9	21.1
Net investment income	6.7	5.3	5.1	5.0	5.2
Net realized gains (losses) on securities and other	3.4	(0.1)	2.2	0.0	(0.1)
Total revenues	317.1	213.1	154.7	125.4	139.4
Insurance losses and loss adjustment expenses	168.2	100.7	93.9	72.5	69.1
Selling, general and administrative costs	74.5	59.7	53.9	47.5	53.2
Interest expense	6.4	6.2	7.6	8.8	6.7
Total expenses	249.1	166.6	155.4	128.8	129.0
Income (loss) before income taxes	68.0	46.5	(0.7)	(3.4)	10.4
Income tax expense (benefit)	24.9	15.5	(1.1)	(1.7)	2.8
Net income (loss)	$ 43.1	$ 31.0	$ 0.4	$ (1.7)	$ 7.6
Net income (loss) available to common shareholders	$ 42.7	$ 30.5	$ (0.1)	$ (2.2)	$ 7.0
Operating Data:					
Gross premiums written(1)	$ 435.2	$ 335.2	$ 238.7	$ 179.4	$ 156.5
Net premiums written(2)	295.1	181.0	112.9	72.5	77.3
Gross revenues(3)	523.8	403.3	295.4	230.9	204.3
Net income (loss) adjusted for write-off of reinsurance recoverables from Reliance Insurance Company(4)	43.1	31.0	7.8	(1.7)	7.6
Balance Sheet Data:					
Cash, cash equivalents and total investments	$ 353.6	$ 213.3	$ 145.2	$ 91.4	$ 100.8
Total assets	751.2	569.1	433.0	335.2	291.9
Total liabilities and redeemable preferred stock	573.8	509.9	402.0	303.5	259.6
Total shareholders equity	177.4	59.2	31.0	31.7	32.3

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	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions, except per share data)				
Per Share Data(5):					
Earnings per common share:					
Basic	$ 2.74	$ 2.30	$ (0.01)	$ (0.17)	$ 0.53
Diluted(6)	2.20	1.68	(0.01)	(0.17)	0.43
Book value per common share	8.31	4.12	1.62	1.69	1.73
Weighted average shares outstanding:					
Basic	15,609,411	13,264,452	13,366,404	13,307,868	13,307,868
Diluted(6)	19,679,610	18,733,056	18,918,096	18,928,056	18,928,080
Common shares outstanding	21,350,640	12,119,148	13,447,512	13,307,868	13,307,868

(1) Gross premiums written is the sum of direct premiums written and assumed premiums written. Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. Assumed premiums written is the sum of total premiums associated with the insurance risk transferred to us by other insurance companies pursuant to reinsurance contracts. See Note 7 to our audited consolidated financial statements included in this prospectus.

(2) Net premiums written is the sum of direct premiums written and assumed premiums written less ceded premiums written. Ceded premiums written is the portion of our direct and assumed premiums written that we transfer to our reinsurers in accordance with the terms of our reinsurance contracts based upon the risks they accept. See Note 7 to our audited consolidated financial statements included in this prospectus.

(3) Gross revenues is the sum of direct premiums written and assumed premiums written (which we refer to in this prospectus as gross premiums written) plus all other revenues (finance income, commission and service fee income, net investment income and net realized gains (losses) on securities). We consider gross revenues to be a non-GAAP financial measure and have provided, in Management s Discussion and Analysis of Financial Condition and Results of Operations Measurement of Results , an explanation of why we believe gross revenues is a financial measure that is useful to management and investors and a reconciliation of gross revenues to total revenues, which is the most directly comparable GAAP financial measure included in our financial statements.

(4) Net income for the year ended December 31, 2001 reflects a $7.4 million after-tax loss attributable to a write-off of reinsurance recoverables from Reliance Insurance Company. We consider net income (loss) adjusted for write-off of reinsurance recoverables from Reliance Insurance Company to be a non-GAAP financial measure. Because we have not had any other material write-offs of reinsurance recoverables in our history, we believe that the $7.8 million adjusted net income ($0.4 million reported net income plus the $7.4 million after-tax impact of the write-off) is useful to management and investors in understanding our improvement in operating results from 2000 to 2003. See Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Overview of Operating Results .

(5) Adjusted to reflect a 12 for 1 stock split that became effective prior to the closing of our initial public offering in August 2003.

(6) Includes the weighted average common shares outstanding and assumes conversion of our Series A redeemable preferred stock and Series B preferred stock because both series of preferred stock were convertible at the option of the holders and were dilutive. Also includes the dilutive effect of the common stock warrant which was exercised upon the closing of our initial public offering; however, for the years ended December 31, 2002, 2001, 2000 and 1999, the warrant was anti-dilutive and was not included in those periods.

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RISK FACTORS

An investment in our common stock involves a number of risks. You should carefully consider the following information about these risks, together with the other information contained in this prospectus, before investing in shares of our common stock. Any of the risks described below could result in a significant or material adverse effect on our results of operations or financial condition and a corresponding decline in the market price of our common stock. These are not the only risks we face, but are the ones we believe may be material. Additional risks not known to us or currently deemed immaterial could also materially and adversely affect our business or results of operations.

Risks Related to Our Business

Because our core product is non-standard personal automobile insurance, our business may be adversely affected by negative developments in the conditions in this industry.

Approximately 97% of our gross premiums written for 2003 were generated from sales of non-standard personal automobile insurance policies. As a result of our concentration in this line of business, negative developments in the economic, competitive or regulatory conditions affecting the non-standard personal automobile insurance industry could have a material adverse effect on our results of operations and financial condition. In addition, these developments could have a greater effect on us, compared to more diversified insurers that also sell other types of automobile insurance products.

For example, in the late 1990s, the automobile insurance industry experienced severe price competition, rapidly rising medical costs and high levels of fraudulent claims which resulted in a significant deterioration in underwriting profitability. According to the Insurance Information Institute, an insurance industry research organization, the cost of automobile insurance declined in 1998 and 1999. During this same period and in 2000, as indicated in this report, the amount of claims paid by automobile insurers rose sharply, particularly with respect to personal injury claims. The combination of these events adversely impacted our underwriting results and the underwriting results of most of our competitors.

Because of the currently favorable pricing conditions in our industry, it is likely that new competitors will enter the market and existing insurers will attempt to increase market share by lowering rates. These conditions could cause us to lose market share or have a material adverse effect on our underwriting results due to a reduction in our underwriting margin.

Because we write a substantial number of insurance policies in Florida and Tennessee, our business may be adversely affected by conditions in these states.

In 2003, approximately 51% and 14% of our gross premiums written were generated from non-standard personal automobile and life insurance policies written in Florida and Tennessee, respectively. Our revenues and profitability are affected by the prevailing regulatory, economic, demographic, competitive and other conditions in these states. For example, from 1998 through 2001, our underwriting results in Florida were adversely affected by high levels of fraudulent claims and increased price competition. Changes in any of these conditions could make it more costly or difficult for us to conduct our business. Adverse regulatory developments in Florida or Tennessee, which could include reductions in the maximum rates permitted to be charged, restrictions on rate increases or fundamental changes to the design or implementation of the automobile insurance regulatory framework, could have a material adverse effect on our results of operations and financial condition.

Severe weather conditions and other catastrophes may result in an increase in the number and amount of claims filed against us.

Our business is exposed to the risk of severe weather conditions and other catastrophes. Catastrophes can be caused by various events, including natural events such as severe winter weather, hurricanes, tornadoes, windstorms, earthquakes, hailstorms, severe thunderstorms and fires, and other events such as explosions, terrorist attacks and riots. The incidence and severity of catastrophes and severe weather conditions are

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inherently unpredictable. Severe weather conditions generally result in higher incidence of automobile accidents and an increase in the number of claims filed as well as the amount of compensation sought by claimants.

Because some of our insureds live near the coastlines of the Atlantic Ocean and the Gulf of Mexico, we have potential exposure to catastrophic losses related to hurricanes and major coastal storms. We currently maintain property catastrophe excess of loss reinsurance, excluding terrorism and acts of war, that provides coverage for losses up to $15 million, less our retention of both 100% of the first $2.0 million of losses and 2.5% of losses covered under this reinsurance arrangement. In the event a major catastrophe were to occur resulting in property losses to us in excess of our coverage, our losses could have a material adverse effect on our results of operations and financial condition.

Our business is highly competitive, which may make it difficult for us to market our core products effectively and profitably.

The non-standard personal automobile insurance business is highly competitive. We compete with other insurers that, in most cases, sell through independent agencies. We also compete with insurers that sell insurance policies directly to their customers. We believe that our primary insurance company competition comes not only from national companies or their subsidiaries, such as the Progressive insurance group, the Allstate insurance group, the Infinity insurance group, the State Farm insurance group, the Berkshire Hathaway insurance group (including GEICO) and the Bristol West insurance group, but also from non-standard insurers and independent agents that operate in a specific region or single state in which we operate.

Based upon written premium data compiled from A.M. Best, we believe that, as of December 31, 2002, ten insurance groups accounted for approximately 70% of the approximately $30 billion non-standard market segment. Further, based upon our direct written premiums for 2002, we believe that, as of December 31, 2002, we would be ranked 17th nationally and sixth in the nine states in which we operated among non-standard automobile insurers, using the 2002 market data compiled from A.M. Best.

Some of our competitors have substantially greater financial and other resources than we have, and they may offer a broader range of products or offer competing products at lower prices. Our results of operations and financial condition could be materially and adversely affected by a loss of business to competitors offering similar insurance products at lower prices or having other competitive advantages.

Our results may fluctuate as a result of cyclical changes in the personal automobile insurance industry.

The personal automobile insurance industry is cyclical in nature. In the past, the industry has been characterized by periods of price competition and excess capacity followed by periods of high premium rates and shortages of underwriting capacity. We believe that during 2001, 2002 and 2003, the underwriting results in the personal automobile insurance industry improved as a result of favorable pricing and competitive conditions that allowed for broad increases in rate levels by insurers. However, new competitors may enter this market and existing competitors may attempt to increase market share by lowering rates. Such conditions would cause a downturn in the current cycle and could negatively impact our revenues and profitability.

Current ratings of our insurance subsidiaries or any failure of our insurance subsidiaries to maintain current financial strength ratings could materially and adversely affect our business and our ability to obtain financing or reinsurance at favorable rates.

A.M. Best provides a variety of products and services to the insurance industry and is generally considered to be a leading authority on insurance company ratings and information. Three of our property and casualty insurance subsidiaries have been assigned a B (Fair) rating and our other property and casualty insurance subsidiary has been assigned a B- (Fair) rating. A.M. Best assigns 15 ratings to insurance companies, which currently range from A++ (Superior) to F (In Liquidation) .

B (Fair) and B- (Fair) are the seventh and eighth highest ratings, respectively, issued by A.M. Best. Publications of A.M. Best indicate that the B (Fair) and B- (Fair) rating is assigned to those

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companies that in A.M. Best s opinion have a fair ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions. In evaluating a company s financial and operating performance, A.M. Best reviews the company s profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its loss reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best s ratings reflect its opinion of an insurance company s financial strength, operating performance, and ability to meet its obligations to policyholders and are not evaluations directed to potential or current investors in our common stock and are not recommendations to buy, sell, or hold our common stock.

Financial institutions and reinsurance companies use the A.M. Best insurance ratings to help assess the financial strength and quality of insurance companies. The current ratings of our property and casualty insurance subsidiaries or their failure to maintain such ratings may dissuade a financial institution or reinsurance company from conducting business with us or increase our interest or reinsurance costs. See Business Ratings .

Our principal shareholder has the ability to control our operations, including the election of our directors.

The William C. Adair, Jr. Trust, over which Ms. Tammy Adair, our Executive Vice President, has sole voting control, beneficially owns approximately 28.96% of our common stock and after this offering will own approximately 21.44% of our common stock. Ms. Adair, as trustee, has the ability to affect significantly the composition of our board of directors and the approval of any action requiring a shareholder vote, including amendments to our charter or bylaws and approvals of mergers or sales of substantially all of our assets. The interests of the trustee and the beneficiaries of the trust may differ from the interests of our other shareholders. See Principal and Selling Shareholders .

As a holding company, we are dependent on the results of operations of our operating subsidiaries and the regulatory and contractual capacity of our operating subsidiaries to pay dividends to us.

We are a holding company and a legal entity separate and distinct from our operating subsidiaries. As a holding company without significant operations of our own, the principal sources of our funds are dividends and other payments from our operating subsidiaries. State insurance laws limit the ability of our insurance subsidiaries to pay dividends and require our insurance subsidiaries to maintain specified minimum levels of statutory capital and surplus. These restrictions affect the ability of our insurance subsidiaries to pay dividends to us without prior notice to, or approval of, regulatory authorities and the timing of such payments. During 2004, our insurance subsidiaries will be able to pay maximum dividends of $10.5 million to Direct General Corporation without seeking regulatory approval. Dividends from our premium finance subsidiary are limited by the minimum capital requirements in applicable state regulations and by covenants in our loan agreements that require approval of our lenders. There are no other restrictions on payments of dividends from our subsidiaries except for typical state corporation law requirements. Consequently, our ability to repay debts, pay expenses and pay cash dividends to our shareholders may be limited. See Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Liquidity and Capital Resources Sources and Uses of Funds and Business Regulatory Environment Restrictions on Paying Dividends .

We are subject to comprehensive regulation that may restrict our ability to earn profits.

Our insurance, agency and premium finance subsidiaries are subject to comprehensive regulation and supervision by the insurance and financial institution departments in the states where our subsidiaries are domiciled and where our subsidiaries sell insurance products, issue policies, finance premiums and handle claims. Certain regulatory restrictions and prior approval requirements may affect our subsidiaries ability to operate, innovate, obtain necessary rate adjustments in a timely manner or may increase our cost and reduce profitability.

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Supervision and regulation by insurance and financial institution departments extend, among other things, to:

Required Licensing. We operate under licenses issued by various state insurance, consumer credit and banking authorities. These licenses govern, among other things, the types of insurance coverages, agency and claims services, and premium finance products that we may offer consumers in these states. Such licenses typically are issued only after we file an appropriate application and satisfy prescribed criteria. We must apply for and obtain the appropriate new licenses before we can implement any plan to expand into a new state or offer a new line of insurance or other new product that requires separate licensing. If a regulatory authority denies or delays granting such new license, our ability to enter new markets quickly or offer new products we believe will be profitable can be substantially impaired. See Business Regulatory Environment Required Licensing.

Transactions Between Insurance Companies and Their Affiliates. We operate as an insurance holding company system and are subject to regulation in the jurisdictions in which our insurance subsidiaries conduct business. Our insurance subsidiaries are organized and domiciled or commercially domiciled under the insurance statutes of Delaware, Florida, Georgia, Louisiana, Mississippi, South Carolina and Tennessee. The insurance laws in these states provide that all transactions among members of an insurance holding company system must be fair and reasonable. Transactions between our insurance subsidiaries and other members of our holding company system generally must be disclosed to the state regulators, and prior approval of the applicable regulator generally is required before any material or extraordinary transaction may be consummated. State regulators may refuse to approve or delay approval of such a transaction, which may impact our ability to innovate or operate efficiently. See Business Regulatory Environment Insurance Holding Company Regulation.

Regulation of Premium Rates and Approval of Policy Forms. The insurance laws of most states in which our insurance subsidiaries operate require insurance companies to file premium rate schedules and insurance policy forms for review and approval. State insurance regulators have broad discretion in judging whether our rates are adequate, not excessive and not unfairly discriminatory. The speed at which we can change our rates in response to competition or to increasing costs depends, in part, on the method by which the applicable state s rating laws are administered. Generally, state insurance regulators have the authority to disapprove our requested rates. Thus, if as permitted in some states, we begin using new rates before they are approved, we may be required to issue premium refunds or credits to our policyholders if the new rates are ultimately deemed excessive or unfair and disapproved by the applicable state regulator. In addition, in some states, there has been some pressure in past years to reduce premium rates for automobile and other personal insurance or to limit how often an insurer may request increases for such rates. In states where such pressure is applied, our ability to respond to market developments or increased costs in that state can be adversely affected. See Business Regulatory Environment Regulation of Rates and Policy Forms.

Investment Restrictions. Our insurance subsidiaries are subject to state laws and regulations that require diversification of their investment portfolios and that limit the amount of investments in certain categories. Failure to comply with these laws and regulations would cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture. See Business Regulatory Environment Investment Regulation.

Restrictions on Cancellation, Non-Renewal or Withdrawal. Many states have laws and regulations that limit an insurer s ability to exit a market. For example, certain states limit an automobile insurer s ability to cancel or not renew policies. Some states prohibit an insurer from withdrawing from one or more lines of business in the state, except pursuant to a plan approved by the state insurance department. The state insurance department may disapprove a plan that may lead to market disruption. To date, none of these restrictions has had an impact on our operations or strategic planning in the states in which we operate. However, these laws and regulations that limit cancellations and non-renewals and that subject business withdrawals to prior approval restrictions could limit our ability to exit unprofitable markets or discontinue unprofitable products in the future. See Business Regulatory Environment Restrictions on Cancellation, Non-Renewal or Withdrawal.

Other Regulations. We must also comply with regulations involving, among other things:

the use of non-public consumer information and related privacy issues;

investment restrictions;

the use of credit history in underwriting and rating;

the payment of dividends;

the acquisition or disposition of an insurance company or of any company controlling an insurance company;

the involuntary assignments of high-risk policies, participation in reinsurance facilities and underwriting associations, assessments and other governmental charges;

reporting to state regulators with respect to financial condition;

periodic reporting, corporate governance and other compliance requirements imposed by the Sarbanes-Oxley Act of 2002 and other federal laws and regulations applicable to publicly traded companies; and

rules and regulations of the Nasdaq National Market, on which our common stock is listed for trading.

In addition, our premium finance business is subject to the federal Truth-in-Lending Act and similar state statutes, and in states where premium finance statutes have not been enacted, we generally are subject to state usury laws that are applicable to consumer loans. See Business Regulatory Environment .

Regulation may become more extensive in the future, which may adversely affect our business.

We cannot assure you that states will not make existing insurance laws and regulations more restrictive in the future or enact new restrictive laws. In such events, we may seek to reduce our writings in, or to withdraw entirely from, these states. In addition, from time to time, the United States Congress and certain federal agencies investigate the current condition of the insurance industry to determine whether federal regulation is necessary. We are unable to predict whether and to what extent new laws and regulations that would affect our business will be adopted in the future, the timing of any such adoption and what effects, if any, they may have on our operations, profitability and financial condition.

Our insurance and premium finance subsidiaries are subject to capital requirements, and our failure to meet these standards could subject us to regulatory actions.

Our insurance subsidiaries are subject to risk-based capital standards (which we refer to in this prospectus as RBC standards) and other minimum capital and surplus requirements imposed under the laws of their states of domicile. The RBC standards, based upon the RBC Model Act adopted by the National Association of Insurance Commissioners (which we refer to in this prospectus as the NAIC) require our insurance subsidiaries to report their results of risk-based capital calculations to the state departments of insurance and the NAIC. Our premium finance subsidiary is subject to minimum capital requirements imposed under the laws of some of the states in which it conducts business.

Failure to meet applicable risk-based capital requirements or minimum statutory capital requirements could subject our insurance subsidiaries or our premium finance subsidiary to further examination or corrective action imposed by state regulators, including limitations on our writing of additional business or engaging in finance activities, state supervision or even liquidation. Any changes in existing RBC requirements or minimum statutory capital requirements may require us to increase our statutory capital levels, which we may be unable to do. As of December 31, 2003, each of our insurance subsidiaries maintained an RBC level that is in excess of an amount that would require any corrective actions on our part and our premium finance subsidiary was in compliance with the minimum capital requirements of the applicable state regulations. See Business Regulatory Environment .

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New pricing, claim, coverage and financing issues and class action litigation are continually emerging in the automobile insurance industry, and these new issues could adversely impact our revenues or our methods of doing business.

As automobile insurance industry practices and regulatory, judicial and consumer conditions change, unexpected and unintended issues related to claims, coverages, business practices and premium financing plans may emerge. These issues can have an adverse effect on our business by changing the way we price our products, by extending coverage beyond our underwriting intent, or by increasing the size of claims. Recent examples of some emerging issues include:

- concerns over the use of an applicant s credit score and zip code as a factor in making risk selections and pricing decisions;
- a growing trend of plaintiffs targeting automobile insurers, including us, in purported class action litigation relating to claims-handling practices, such as the permitted use of aftermarket (non-original equipment manufacturer) parts, total loss evaluation methodology and the alleged diminution in value to insureds vehicles involved in accidents;
- a relatively new trend of plaintiffs targeting insurers, including automobile insurers, in purported class action litigation which seek to recharacterize installment fees and other allowed charges related to insurers installment billing programs (which we currently do not employ, but could implement in the future) as interest that violates state usury laws or other interest rate restrictions; and
- attempts by plaintiffs to initiate purported class action litigation targeting premium finance operations relating to unearned interest rebates and the collection of service and finance charges.

The effects of these and other unforeseen emerging issues could negatively affect our revenues or our methods of doing business.

Our assumed reinsurance arrangements may be deemed to be the unauthorized business of insurance.

Our agency subsidiaries have sold non-standard automobile insurance for State National Specialty Insurance Company in North Carolina and currently sell non-standard automobile insurance in North Carolina for that company s affiliate, State National Insurance Company. We also service, finance and administer claims related to this business. One of our insurance subsidiaries reinsures a 100% quota share percentage of State National s physical damage business in North Carolina. In January 2003, we began assuming a 100% quota share percentage of the non-standard personal automobile liability and physical damage business in Texas underwritten by Old American County Mutual Fire Insurance Company, an unaffiliated insurance company, for which we are responsible for the sales, service, and claims administration related to such business.

We believe that these arrangements comply with applicable law and we are not aware of any pending regulatory or legislative action that could affect these arrangements. However, we can provide no assurance that the state legislatures or insurance regulators of North Carolina and Texas will continue to permit these types of assumed reinsurance arrangements whereby all or substantially all of the insurance risk is transferred to a single assuming reinsurer that is not a licensed insurer in that state. If not, then insurance regulators in these states could construe our assumed reinsurance arrangements as the conduct of the unauthorized business of insurance by us, or the aiding and abetting by the policy issuing companies of the unauthorized business of insurance. Any such adverse regulatory decision may have a material adverse effect on our results of operations.

Our largely fixed cost structure would work to our disadvantage if our sales volume were to decline significantly.

Because of our emphasis on the use of employee-agents, our cost of acquiring business is largely fixed. In times of increasing sales volume, our acquisition cost per policy decreases, improving our expense and combined ratios, which we believe is one of the significant advantages of our business model. However, in

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times of declining sales volume, the opposite would occur. A decline in sales volume could decrease our profitability, cause us to close some of our neighborhood sales offices or lay-off employee-agents to manage our expenses.

Our inability to refinance our current lines of credit or obtain additional financing could have an adverse effect on our premium finance revenue.

Through our premium finance subsidiary, we finance almost all of the insurance policies we sell. Our working capital needs are substantially dependent on bank lines of credit that include covenants requiring us to pass specified financial tests and to refrain from certain kinds of actions. Such actions include incurring or guaranteeing additional indebtedness; granting mortgages or liens on our and certain of our subsidiaries assets; selling our premium finance subsidiary receivables; merging into, consolidating with, or acquiring the assets of another business corporation outside defined limitations; disposing of all or a substantial portion of our assets; making loans or investments other than to our subsidiaries; or entering into a new line of business not related to insurance, financial and related services. In the event we fail to meet our covenants or are unable to refinance, replace or increase our bank line of credit on economically feasible terms, our income and the marketability of our insurance products could be adversely affected. An alternative to financing our policies through our premium finance subsidiary would be to finance or installment bill the policies through our insurance subsidiaries, which would eliminate the requirement for outside working capital. However, certain regulatory restrictions may make it more difficult to finance other insurance products which could adversely affect our results of operations.

Our losses and loss adjustment expenses may exceed our reserves, which would adversely impact our results of operations and financial condition.

We record reserve liabilities for the estimated payment of losses and loss adjustment expenses for both reported and unreported claims. The amount of reserves is based on historical claims information, industry statistics and other factors. The establishment of appropriate reserves is an inherently uncertain process. This uncertainty arises from a number of factors, including the difficulty in predicting the rate of inflation and the rate and direction of changes in trends, ongoing interpretation of insurance policy provisions by courts, inconsistent decisions in lawsuits regarding coverage and expanded theories of liability. In addition, ongoing changes in claims settlement practices can lead to changes in loss payment patterns, which are used to estimate reserve levels. If our reserves prove to be inadequate, we would be required to increase them and would charge the amount of such increase to our earnings in the period in which the deficiency is recognized. Due to the inherent uncertainty of estimating reserves, it has been necessary, and will over time continue to be necessary, to revise estimated future liabilities as reflected in our reserves for claims and policy expenses, and these revisions can cause our results to fluctuate. For the year ended December 31, 2003, we experienced adverse reserve development that increased our losses and loss adjustment expenses incurred by $0.1 million. During the year ended December 31, 2002, our reserves for prior years developed favorably, which resulted in reductions in losses and loss adjustment expenses incurred of $5.5 million. For the year ended December 31, 2001, we experienced adverse reserve development that increased our losses and loss adjustment expenses incurred by $7.8 million. See Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Expenses Insurance Losses and Loss Adjustment Expenses for a discussion of the reasons for these changes. The historic development of reserves for losses and loss adjustment expenses may not necessarily reflect future trends in the development of these amounts. Consequently, ultimate losses could materially exceed loss reserves and have a material adverse effect on our results of operations and financial condition. See Business Regulatory Environment .

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We are party to litigation, which, if decided adversely to us, could affect our business, results of operations or financial condition.

We are named as a defendant in various legal actions arising out of claims made in connection with our insurance policies, our premium finance agreements, other contracts we have entered into, our relationships with our employees and other matters. These legal actions include nine purported class action lawsuits:

- one alleges we wrongfully calculated unearned interest rebates owed to customers on prepaid premium finance accounts;
- six allege we violated Florida law regarding payments to medical magnetic resonance imaging providers;
- one alleges we improperly cancelled insurance policies; and
- one alleges we charged and collected unlawful service and finance charges with respect to the financing of purported automobile club memberships in violation of Florida law.

In addition, during 2003 we settled a class action lawsuit in Tennessee in which approximately 130 persons purported to give notice that they elected not to participate in the settlement. Some or all of these persons could file individual actions or join together and file an additional purported class action lawsuit. A majority of these persons are represented by a single law firm; this increases the risk that an additional class action lawsuit may be filed.

We intend to vigorously defend each of these lawsuits. However, all litigation is unpredictable and the ultimate outcome of these cases is uncertain. These matters are in their early procedural stages, and thus we are unable to predict the likelihood or range of our potential liability or the potential financial impact on our future operations, if we are not able to successfully defend or settle these cases. Also, we are unable to predict the effect that these pending lawsuits, or similar lawsuits filed against us in the future, may have on our business, financial condition and results of operations.

In addition, our Chairman, Chief Executive Officer and President has been named as a defendant in a lawsuit that alleges misrepresentation and breach of contract that resulted in a loss of commissions to the plaintiff. We are not named as a defendant in this lawsuit; however, the plaintiff s counsel has recently stated an intention to add us as a defendant. If we are named as a defendant in this lawsuit, we will vigorously defend against any claims. See Business Legal Proceedings .

If we lose key personnel or are unable to recruit qualified personnel, our ability to implement our business strategies could be delayed or hindered.

Our future success will depend, in part, upon the efforts of our executive officers. The loss of any of these officers or other key personnel could prevent us from fully implementing our business strategies and could materially and adversely affect our business, financial condition and results of operations. We have employment agreements with William C. Adair, Jr., Jacqueline C. Adair, Tammy R. Adair, Barry D. Elkins and William J. Harter. See Management Employment Agreements . We do not have key person insurance on the lives of any of our key management personnel. As we continue to grow, we will need to recruit and retain additional qualified management personnel, but we may not be able to do so. Our ability to recruit and retain such personnel will depend upon a number of factors, such as our results of operations and prospects and the level of competition then prevailing in the market for qualified personnel. See Management Directors and Executive Officers .

Our investment portfolio may suffer reduced returns or losses which could reduce our profitability.

Our results of operations depend, in part, on the performance of our invested assets. As of December 31, 2003, 99.5% of the fair value of our investment portfolio was invested in debt securities, primarily in liquid state, municipal, corporate and federal government bonds and 0.5% in other short-term investments. Fluctuations in interest rates affect our returns on, and the fair value of, fixed income securities. Unrealized gains and losses on debt securities are recognized in other comprehensive income and increase or decrease our

shareholders equity. As of December 31, 2003 and 2002, pretax net unrealized gains in our investment portfolio amounted to $1.1 million and $4.3 million, respectively. Interest rates in the United States are currently low relative to recent historical levels. Based on data compiled from Bloomberg L.P., the pretax yield on U.S. Treasury securities with a five-year maturity has steadily declined over the past few years from approximately 6.3% at December 31, 1999 to approximately 3.2% at December 31, 2003. An increase in interest rates could reduce the fair value of our investments in debt securities. As of December 31, 2003, the impact of an immediate 100 basis point increase in market interest rates on our debt securities portfolio would have resulted in an estimated decrease in fair value of 4.1% or approximately $10.8 million. In addition, defaults by third parties who fail to pay or perform obligations could reduce our investment income and realized investment gains and could result in investment losses to our portfolio. See Management s Discussion and Analysis of Financial Condition and Results of Operations Investments .

We may not be successful in reducing our risk and increasing our underwriting capacity through reinsurance arrangements, which could adversely affect our business, financial condition and results of operations.

In order to reduce our underwriting risk and increase our underwriting capacity, we transfer portions of our insurance risk to other insurers through reinsurance contracts. Historically, we have ceded a portion of our non-standard automobile insurance premiums and losses to unaffiliated reinsurers in accordance with these contracts. However, we have not ceded any portion of our life insurance premiums and losses to reinsurers since the life premium volume is relatively low. Ceded premiums written were equal to 32.2%, 46.0% and 52.7% of our gross premiums written for the years ended December 31, 2003, 2002 and 2001, respectively. The availability, cost and structure of reinsurance protection is subject to changing market conditions, which are outside of our control. In order for these contracts to qualify for reinsurance accounting and thereby provide the additional underwriting capacity that we desire, the reinsurer generally must assume significant risk and have a reasonable possibility of a significant loss.

Although the reinsurer is liable to us to the extent we transfer, or cede, risk to the reinsurer, we remain ultimately liable to the policyholder on all risks reinsured. As a result, ceded reinsurance arrangements do not limit our ultimate obligations to policyholders to pay claims. We are subject to credit risks with respect to the financial strength of our reinsurers. We are also subject to the risk that our reinsurers may dispute their obligations to pay our claims. As a result, we may not recover claims made to our reinsurers in a timely manner, if at all. As of December 31, 2003, we had a total of $32.7 million of unsecured reinsurance recoverables, which represented 18.4% of our total shareholders equity, and our largest unsecured recoverable from a single reinsurer was $9.2 million, which represented 5.2% of our total shareholders equity. In addition, if insurance departments deem that under our existing or future reinsurance contracts the reinsurer does not assume significant risk and has a reasonable possibility of significant loss, we may not be able to increase our ability to write business based on this reinsurance. Any of these events could have a material adverse effect on our business, financial condition and results of operations.

Because we have reduced our use of quota share reinsurance, we will retain more risk, which could result in losses.

We currently use quota share reinsurance primarily to increase our underwriting capacity and to reduce our exposure to losses. Quota share reinsurance refers to a form of pro rata reinsurance arrangement pursuant to which the reinsurer participates in a specified percentage of the premiums and losses on every risk that comes within the scope of the reinsurance agreement. See Management s Discussion and Analysis of Financial Condition and Results of Operations Reinsurance and Business Reinsurance . During 2003, we reduced, but did not eliminate, our use of quota share reinsurance. Thus, we will retain and earn more of the premiums we write, but also retain more of the related losses. Reducing our use of quota share reinsurance has increased our risk and exposure to such losses, which could have a material adverse effect on our business, financial condition and results of operations.

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We rely on our information technology and telecommunication systems, and the failure of these systems could materially and adversely affect our business.

Our business is highly dependent upon the successful and uninterrupted functioning of our information technology and telecommunications systems. We rely on these systems to support our direct marketing operations, as well as to process new and renewal business, provide customer service, make claims payments, support premium financing activities, and facilitate collections and cancellations. These systems also enable us to perform actuarial and other modeling functions necessary for underwriting and rate development. We have a highly trained staff that is committed to the continual development and maintenance of these systems. However, the failure of these systems could interrupt our operations or materially impact our ability to evaluate and write new business. Because our information technology and telecommunications systems interface with and depend on third party systems, we could experience service denials if demand for such service exceeds capacity or such third party systems fail or experience interruptions. If sustained or repeated, a system failure or service denial could result in a deterioration of our ability to write and process new and renewal business and provide customer service or compromise our ability to pay claims in a timely manner. This could result in a material adverse effect on our business. See Business Technology .

We maintain insurance on our real property and other physical assets. This insurance will not compensate us for losses that may occur due to disruptions in service as a result of a computer, data processing or telecommunication systems failure that is unrelated to covered property damage, nor will such insurance necessarily compensate us for all losses resulting from covered events. We maintain redundant systems or facilities for our principal information services to help maintain functionality and reduce the risk of significant interruptions of our operations.

We may have difficulties in managing our expansion into new markets, and we may not be successful in identifying agency acquisition candidates or integrating their operations.

Our future growth plans include expanding into new states by acquiring the business and assets of local agencies, opening new sales offices, introducing additional insurance products, and retaining more of our insurance risk by reducing our use of reinsurance. Our future growth will face risks, including risks associated with obtaining necessary licenses, the proper design and pricing of our products, our ability to identify, hire and train new claims and sales employees and our ability to identify agency acquisition candidates or, if acquired, to integrate their operations. In addition, we may acquire business in states in which market and other conditions may not be favorable to us. For example, we commenced writing business in Florida in 1998 through the acquisition of the business and assets of a 64 office agency, and continued our expansion into Florida in 1999 by arranging to distribute our policies through a 42 office independent insurance agency, the assets and business of which we acquired in 2003. Our entrance into the Florida market was at the beginning of a period of significant deterioration of results due largely to increased levels of state-wide fraud in Florida s required personal injury protection coverage that was further compounded by a period of increased price competition. Accordingly, from 1998 to 2000, our overall loss ratio increased approximately 24 points due to the results of our Florida business.

Our inability to identify and acquire agency acquisition candidates could hinder our growth by slowing down our ability to expand into new states. If we do acquire additional agencies, we could suffer increased costs, disruption of our business and distraction of our management if we are unable to integrate the acquired agencies into our operations smoothly. Our expansion will also continue to place significant demands on our management, operations, systems, accounting, internal controls and financial resources. Any failure by us to manage our growth and to respond to changes in our business could have a material adverse effect on our business, financial condition and results of operations.

Our plans to introduce new insurance and ancillary products and offer administrative services to other insurance companies may prove unsuccessful or subject us to greater liability than anticipated.

We are exploring the possibility of offering additional insurance products, such as renters , homeowners (including mobile homeowners), motorcycle, boat and personal watercraft policies. These additional

insurance products may either be underwritten by unaffiliated insurers, from which we would receive a commission, or underwritten by us, with the majority of the underwriting risk expected to be ceded to unaffiliated reinsurers from which we would receive a ceding commission.

We have also been studying the feasibility of providing other administrative services to third party insurers. Such administrative services could include managing general agency, underwriting and accounting services, reinsurance consulting and other management services provided for a fee to a risk retention group that would provide excess liability stop loss insurance for contractual liabilities of members of the group. These contractual liabilities are expected to initially relate to medical benefits. The fees or commissions we might generate from these services would not involve the assumption by us of any insurance underwriting risk. We are considering providing these other administrative services through our existing subsidiaries or a new subsidiary. Any new subsidiary may either be wholly owned by us or majority owned by us, in which case third party investors would own the remaining equity interests in the new subsidiary.

Since we have no experience in providing the insurance products and types of administrative services discussed above, our attempt to enter these markets and/or provide these services may prove unsuccessful. In order to succeed in these new ventures, we will need to, among other things, establish operating procedures, attract and retain qualified employees with experience in handling these products and services, install management information and other systems relevant to supporting these products and services and complete other tasks necessary to conduct our intended business activities. We cannot assure you that we will be as successful in accomplishing these necessary tasks as we have been in providing our core insurance products. We may also encounter unforeseen situations that might lead to delays in providing these products and services. In addition, we will, to some extent, bear the underwriting risk related to the new insurance products we may offer. The offering of these products and services may subject us to greater liability than we currently anticipate.

Risks Related to this Offering

Provisions contained in our organizational documents and in laws of the state of Tennessee and other states in which we conduct business could impede an attempt to replace or remove our management or prevent the sale of our company, which could diminish the value of our common stock.

Our charter, bylaws and the laws of the state of Tennessee and other states in which our insurance and premium finance subsidiaries conduct business contain provisions that may delay, deter or prevent a takeover attempt that shareholders might consider to be in their best interests. For example, our charter provides for a classified board of directors with staggered terms, prevents shareholders from calling a special meeting of shareholders, provides for supermajority voting requirements to amend certain provisions of our charter and bylaws and provides for the filling of vacancies on our board of directors by the vote of a majority of the directors then in office. These provisions will render the removal of the incumbent board of directors or management more difficult. In addition, these provisions may prevent shareholders from receiving the benefit of any premium over the market price of our common stock offered by a bidder in a potential takeover. Even in the absence of a takeover attempt, the existence of these provisions may adversely affect the prevailing market price of our common stock if they are viewed as discouraging takeover attempts in the future. In addition, we are subject to the Tennessee Business Combination Act, which hinders shareholders owning 10% or more of any class of our outstanding voting stock from engaging in business combinations with us.

The insurance laws of the states in which our insurance subsidiaries are domiciled prohibit any person from acquiring control of us, and thus indirect control of our insurance subsidiaries, without the prior approval of each such states insurance commissioners or applicable state insurance regulatory authority. Generally, these laws presume that control exists where any person, directly or indirectly, owns, controls, holds the power to vote or holds proxies representing 10% or more of our outstanding voting stock. Even persons who do not acquire beneficial ownership of 10% or more of the outstanding shares of our voting stock may be deemed to have acquired such control, if the relevant insurance regulatory authorities determine that such control exists in fact. Therefore, any person seeking to acquire a controlling interest in us would face regulatory obstacles, which could delay, deter or prevent an acquisition that shareholders might consider to be in their best

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interests. See Description of Capital Stock Tennessee Law and Our Charter and Bylaw Provisions; Anti-Takeover Effects .

Future sales of shares of our common stock by our existing shareholders in the public market, or the possibility or perception of such future sales, could adversely affect the market price of our stock.

We are a party to separate agreements with certain shareholders whereby we are obligated to register the shares of common stock that they acquired through the conversion of preferred stock. See Description of Capital Stock Registration Rights . These agreements cover approximately 1,000,000 shares of our common stock. We cannot predict what effect, if any, future sales of shares by these persons, their affiliates or other shareholders or the availability of shares for future sale, may have on the prevailing market price of our common stock from time to time. Sales of substantial amounts of our common stock in the public market by these persons, their affiliates or our other shareholders, or the possibility or perception that such sales could occur, could adversely affect prevailing market prices for our common stock. See Common Stock Eligible for Future Sale . If such sales reduce the market price of our common stock, our ability to raise additional capital in the equity markets may be adversely affected. Subject to some limited exceptions, all of our directors, executive officers and the selling shareholders have entered into 90-day lock-up agreements as described in Common Stock Eligible for Future Sale .

The price of our stock may become volatile.

The trading price of our common stock following this offering may fluctuate substantially. The price of our common stock that will prevail in the market after this offering may be higher or lower than the price you pay, depending on many factors, some of which are beyond our control and may not be related to our operating performance. These fluctuations could cause you to lose part or all of your investment in our common stock.

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FORWARD-LOOKING STATEMENTS

Some of the statements under the captions Prospectus Summary , Risk Factors , Management s Discussion and Analysis of Financial Condition and Results of Operations , Business and elsewhere in this prospectus constitute forward-looking statements. You can identify these statements from our use of the words may , should , could , potential , continue , plan , forecast , estimate , project , believe , inten target , is likely , will , or the negative of these terms, and similar expressions. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements may include, among other things:

statements and assumptions relating to future growth, earnings, earnings per share and other financial performance measures, as well as management s short-term and long-term performance goals;

statements relating to the anticipated effects on results of operations or financial condition from recent and expected developments or events;

statements relating to our business and growth strategies; and

any other statements or assumptions that are not historical facts.

We believe that our expectations are based on reasonable assumptions. However, these forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause our actual results, performance or achievements, or industry results, to differ materially from our expectations of future results, performance or achievements expressed or implied by these forward-looking statements. In addition, our past results of operations do not necessarily indicate our future results. We discuss these and other uncertainties in the Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations sections of this prospectus.

You should not place undue reliance on any forward-looking statements. These statements speak only as of the date of this prospectus. Except as otherwise required by applicable laws, we undertake no obligation to publicly update or revise any forward-looking statements or the risk factors described in this prospectus, whether as a result of new information, future events, changed circumstances or any other reason after the date of this prospectus.

SOURCES OF CERTAIN STATISTICAL AND OTHER INFORMATION

This prospectus includes certain statistical and other data with respect to us, our products and services and our industry, derived from publicly available reports and other publications of Insurance Information Institute, Bloomberg L.P. and A.M. Best referenced in this prospectus. These organizations generally use methodology and conventions that they deem appropriate to measure companies within the relevant industry segment. These organizations generally indicate that they have obtained information from sources believed to be reliable, but do not guarantee the accuracy and completeness of such information. While we believe this information to be reliable, we have not independently verified such data.

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USE OF PROCEEDS

We will not receive any proceeds from the sale of shares of our common stock by the selling shareholders. The proceeds, if any, that we receive from the exercise of the underwriters over-allotment option are expected to be used to contribute additional capital to our insurance subsidiaries and for general corporate purposes.

DIVIDEND POLICY

We declared a quarterly dividend of $0.04 per common share on November 7, 2003 for shareholders of record on December 1, 2003, and the dividend was paid on December 15, 2003. We declared a quarterly dividend of $0.04 per common share on February 25, 2004 for shareholders of record on March 1, 2004, and the dividend was paid on March 15, 2004. We presently anticipate continuing the payment of quarterly cash dividends.

The declaration and payment of dividends is subject to the discretion of our board of directors and will depend on our financial condition, results of operations, cash requirements, future prospects, regulatory and contractual restrictions on the payment of dividends by our subsidiaries, and other factors deemed relevant by our board of directors. Further, we may enter into new agreements or incur additional indebtedness in the future which may further prohibit or restrict the payment of dividends. There is no requirement that we must, and we cannot assure you that we will, declare and pay any dividends in the future. Our board of directors may determine to retain such capital for general corporate or other purposes. For a discussion of our cash resources and needs, see Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Liquidity and Capital Resources .

Direct General Corporation is a holding company and a legal entity separate and distinct from our operating subsidiaries. As a holding company without significant operations of our own, our principal sources of funds are dividends and other payments from our operating subsidiaries. The ability of our insurance subsidiaries to pay dividends is subject to limits under insurance laws of the states in which we conduct business. Furthermore, while there are no restrictions on payment of dividends from our agency, administrative, and consumer products subsidiaries, other than typical state corporation law requirements, dividends from our premium finance subsidiary are limited by the minimum capital requirements in state regulations and by covenants in our loan agreements that require approval of our lenders. See Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Liquidity and Capital Resources and Business Regulatory Environment .

PRICE RANGE OF COMMON STOCK

Our common stock has been traded on the Nasdaq National Market under the symbol DRCT since our initial public offering on August 11, 2003. The initial public offering price of our common stock was $21 per share. The following table sets forth, for the periods indicated, the high and low sales prices for our common stock as reported on the Nasdaq National Market:

	High	Low
2004		
First quarter (through March 22, 2004)	$ 36.20	$ 30.64
2003		
Fourth quarter	$ 33.78	$ 25.00
Third quarter (from August 12, 2003)	$ 26.69	$ 23.01

On March 22, 2004, the last quoted sale price of our common stock as reported by the Nasdaq National Market was $34.55 per share. As of March 23, 2004, there were 43 holders of record of our common stock.

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CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2003, on an actual basis. Since all of the shares to be sold in this offering (other than the shares, if any, to be sold upon exercise of the underwriters over-allotment option) are offered by selling shareholders, there are no adjustments to be made for this offering.

	As of December 31, 2003
	($ in thousands)
Debt:	
Premium finance revolving credit agreement	$ 148,000
Capitalized lease obligations and other	5,502
Total debt	153,502
Shareholders equity:	
Preferred stock, no par; 10,000,000 shares authorized and no shares issued	
Common stock, no par; 100,000,000 shares authorized, 21,350,640 shares issued and outstanding	91,853
Retained earnings	85,735
Accumulated other comprehensive income	(193)
Total shareholders equity	177,395
Total capitalization	$ 330,897

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SELECTED HISTORICAL CONSOLIDATED FINANCIAL AND OPERATING DATA

The following tables provide selected historical consolidated financial and operating data of Direct General as of the dates and for the periods indicated. In conjunction with the data provided in the following tables and in order to more fully understand our historical consolidated financial and operating data, you should also read Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the accompanying notes included in this prospectus. We derived our selected historical consolidated financial data as of December 31, 2003 and 2002 and for the years ended December 31, 2003, 2002 and 2001 from our audited consolidated financial statements included in this prospectus. We derived our selected historical consolidated financial data as of December 31, 2001, 2000 and 1999 and for the years ended December 31, 2000 and 1999 from our audited consolidated financial statements not included in this prospectus. The results for past accounting periods are not necessarily indicative of the results to be expected for any future accounting period.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions, except per share data)				
Statement of Operations Data:					
Premiums earned	$ 228.5	$ 145.0	$ 98.0	$ 73.9	$ 91.6
Finance income	44.9	35.7	27.3	24.6	21.6
Commission and service fee income	33.6	27.2	22.1	21.9	21.1
Net investment income	6.7	5.3	5.1	5.0	5.2
Net realized gains (losses) on securities and other	3.4	(0.1)	2.2	0.0	(0.1)
Total revenues	317.1	213.1	154.7	125.4	139.4
Insurance losses and loss adjustment expenses	168.2	100.7	93.9	72.5	69.1
Selling, general and administrative costs	74.5	59.7	53.9	47.5	53.2
Interest expense	6.4	6.2	7.6	8.8	6.7
Total expenses	249.1	166.6	155.4	128.8	129.0
Income (loss) before income taxes	68.0	46.5	(0.7)	(3.4)	10.4
Income tax expense (benefit)	24.9	15.5	(1.1)	(1.7)	2.8
Net income (loss)	$ 43.1	$ 31.0	$ 0.4	$ (1.7)	$ 7.6
Net income (loss) available to common shareholders	$ 42.7	$ 30.5	$ (0.1)	$ (2.2)	$ 7.0
Operating Data:					
Gross premiums written(1)	$ 435.2	$ 335.2	$ 238.7	$ 179.4	$ 156.5
Net premiums written(2)	295.1	181.0	112.9	72.5	77.3
Gross revenues(3)	523.8	403.3	295.4	230.9	204.3
Net income (loss) adjusted for write-off of reinsurance recoverables from Reliance Insurance Company(4)	43.1	31.0	7.8	(1.7)	7.6
Balance Sheet Data:					
Cash, cash equivalents and total investments	$ 353.6	$ 213.3	$ 145.2	$ 91.4	$ 100.8
Total assets	751.2	569.1	433.0	335.2	291.9
Total liabilities and redeemable preferred stock	573.8	509.9	402.0	303.5	259.6
Total shareholders equity	177.4	59.2	31.0	31.7	32.3

Per Share Data(5):					
Earnings per common share:					
Basic	$ 2.74	$ 2.30	$ (0.01)	$ (0.17)	$ 0.53
Diluted(6)	2.20	1.68	(0.01)	(0.17)	0.43
Book value per common share	8.31	4.12	1.62	1.69	1.73
Weighted average shares outstanding:					
Basic	15,609,411	13,264,452	13,366,404	13,307,868	13,307,868
Diluted(6)	19,679,610	18,733,056	18,918,096	18,928,056	18,928,080
Common shares outstanding	21,350,640	12,119,148	13,447,512	13,307,868	13,307,868

	Quarter Ended											
	Dec. 31, 2003	Sept. 30, 2003	June 30, 2003	Mar. 31, 2003	Dec. 31, 2002	Sept. 30, 2002	June 30, 2002	Mar. 31, 2002	Dec. 31, 2001	Sept. 30, 2001	June 30, 2001	Mar. 31, 2001
	(Unaudited) ($ in millions)											
Selected Quarterly Historical Consolidated Financial and Operating Data:												
Gross premiums written(1)	$ 103.0	$ 103.7	$ 87.9	$ 140.6	$ 84.1	$ 77.1	$ 68.4	$ 105.6	$ 58.6	$ 55.0	$ 50.7	$ 74.4
Net premiums written(2)	97.2	74.0	48.0	75.9	44.1	41.5	37.1	58.3	24.3	19.9	27.5	41.2
Gross revenues(3)	125.6	126.4	109.8	161.9	102.4	94.5	83.0	123.4	74.1	68.2	63.8	89.3
Net income	11.4	11.7	10.1	9.8	13.6	7.0	5.8	4.6	4.4	(5.1)	0.5	0.6
Net income adjusted for write-off of reinsurance recoverables from Reliance Insurance Company(4)	11.4	11.7	10.1	9.8	13.6	7.0	5.8	4.6	4.4	2.3	0.5	0.6

(1) Gross premiums written is the sum of direct premiums written and assumed premiums written. Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. Assumed premiums written is the sum of total premiums associated with the insurance risk transferred to us by other insurance companies pursuant to reinsurance contracts. See Note 7 to our audited consolidated financial statements included in this prospectus.

(2) Net premiums written is the sum of direct premiums written and assumed premiums written less ceded premiums written. Ceded premiums written is the portion of our direct and assumed premiums written that we transfer to our reinsurers in accordance with the terms of our reinsurance contracts based upon the risks they accept. See Note 7 to our audited consolidated financial statements included in this prospectus.

(3) Gross revenues is the sum of direct premiums written and assumed premiums written (which we refer to in this prospectus as gross premiums written) plus all other revenues (finance income, commission and service fee income, net investment income and net realized gains (losses) on securities). We consider gross revenues to be a non-GAAP financial measure and have provided, in Management s Discussion and Analysis of Financial Condition and Results of Operations Measurement of Results , an explanation of why we believe gross revenues is a financial measure that is useful to management and investors and a reconciliation of gross revenues to total revenues, which is the most directly comparable GAAP financial measure included in our financial statements.

(4) Net income for the year ended December 31, 2001 reflects a $7.4 million after-tax loss attributable to a write-off of reinsurance recoverables from Reliance Insurance Company. We consider net income (loss) adjusted for write-off of reinsurance recoverables from Reliance Insurance Company to be a non-GAAP financial measure. Because we have not had any other material write-offs of reinsurance recoverables in our history, we believe that the $7.8 million adjusted net income ($0.4 million reported net income plus the $7.4 million after-tax impact of the write-off) is useful to management and investors in understanding our improvement in operating results from 2000 to 2003. See Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Overview of Operating Results .

(5) Adjusted to reflect a 12 for 1 stock split that became effective prior to the closing of our initial public offering in August 2003.

(6) Includes the weighted average common shares outstanding and assumes conversion of our Series A redeemable preferred stock and Series B preferred stock because both series of preferred stock were convertible at the option of the holders and were dilutive. Also includes the dilutive effect of the common stock warrant which was exercised upon the closing of our initial public offering; however, for the years ended December 31, 2002, 2001, 2000 and 1999, the warrant was anti-dilutive and was not included in those periods.

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MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated financial statements and accompanying notes included in this prospectus. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed below and elsewhere in this prospectus, particularly under the caption Risk Factors .

Overview

We are a provider of non-standard personal automobile insurance, premium finance and other insurance and non-insurance products and services. Our operations are concentrated in the southeastern part of the United States. Our business model integrates our insurance, premium finance and agency subsidiaries. Our model also emphasizes the distribution of our products and services through neighborhood sales offices staffed by employee-agents as opposed to commissioned agents. The expansion of our neighborhood sales offices in selected states includes the use of independent insurance agencies, which we generally have options to acquire in the future.

Our core business involves issuing non-standard personal automobile insurance policies. These policies, which are generally issued for the minimum limits of coverage required by state laws, provide coverage to drivers who cannot obtain insurance from standard carriers due to a variety of factors, including the lack of flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle. Customers in the non-standard market generally have higher average premiums for a comparable amount of coverage than customers who qualify for the standard market. The higher average premiums typically result from an increased frequency of losses, which is partially offset by the lower severity of losses resulting from lower limits of coverage. In some states, we produce personal automobile insurance policies for unaffiliated insurance companies through our distribution system. We assume this business from unaffiliated insurers through reinsurance agreements and earn service fees for our agency, underwriting, policy administration and claims adjustment services performed for the unaffiliated insurers.

Through our premium finance subsidiary, we finance the premiums on the majority of the insurance policies that we sell by lending to customers the premium due to the insurance company. We earn fees and interest income from our premium finance operations. These loans are backed by the unearned portion of the insurance premiums being financed, which is the portion of the loan attributable to future periods of coverage. We structure our payment plans and integrate our systems in an attempt to minimize principal losses on our premium finance loans.

We seek to attract customers by developing strong brand name recognition in our markets through our low-cost television advertising campaigns that emphasize our low down payment, flexible payment plans, convenient neighborhood locations and customer service. Our neighborhood offices serve as a network for both product delivery and payment collection. All policy applications are completed in the neighborhood sales offices, and most of our customers revisit these offices at least monthly to make their periodic payments.

Our business model provides our employee-agents with customer contact at the point of sale and when the customer returns to make periodic payments. This contact allows us to offer a variety of products in addition to our core product, non-standard personal automobile insurance. We provide term life insurance policies through our wholly-owned life insurance subsidiary, as well as vehicle protection insurance, travel protection insurance and hospital indemnity insurance underwritten by unaffiliated insurers, for which we receive commission and service fee income. We also offer ancillary non-insurance products and services.

Our revenues are derived principally from:

- premiums we earn from sales of direct and assumed non-standard personal automobile and term life insurance policies, which we refer to in this prospectus as gross premiums, less the portion of those

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- premiums that is ceded to other insurers, which we refer to in this prospectus as ceded premiums, with the difference being what we refer to as net premiums;
- ancillary income, which includes:
  - interest and fees earned on the financing of insurance policies; and
  - commission and service fee income that we earn in connection with the sales and servicing of insurance products underwritten by other insurers and other income; and
- investment income that we earn on the invested assets of our subsidiaries.

Our expenses consist predominately of:

- insurance losses and loss adjustment expenses (which we sometimes refer to in this prospectus as LAE) including estimates for losses incurred during the period and changes in estimates from prior periods related to direct and assumed non-standard personal automobile and term life insurance policies (which we refer to in this prospectus as gross insurance losses and loss adjustment expenses), less the portion of those insurance losses and loss adjustment expenses that are ceded to other insurers (which we refer to in this prospectus as ceded insurance losses and loss adjustment expenses) (we refer to the difference as net insurance losses and loss adjustment expenses); and
- operating expenses that include:
  - selling, general and administrative, or SGA costs, including salaries, advertising, commissions and other expenses of our employee-agent distribution channel reduced by ceding commissions received under our reinsurance agreements; and
  - interest expense under our premium finance revolving credit facility.

Measurement of Results

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our gross revenues, which are comprised of gross premiums written and revenues from all other sources produced through our distribution system. We generally measure our operating results by examining our net income, return on equity, and our loss, expense and combined ratios. In addition, we evaluate our performance by comparing the level of our ancillary income to premiums earned and to operating expenses. The following provides further explanation of the key measures that we use to evaluate our results:

Gross Premiums Written. Gross premiums written is the sum of direct premiums written and assumed premiums written. Direct premiums written is the sum of the total policy premiums, net of cancellations, associated with policies underwritten and issued by our insurance subsidiaries. Assumed premiums written is the sum of total premiums associated with the insurance risk transferred to us by other insurance companies pursuant to reinsurance contracts. See Note 7 to our audited consolidated financial statements included in this prospectus. We use gross premiums written, which excludes the impact of premiums ceded to reinsurers, as a measure of the underlying growth of our insurance business from period to period.

Net Premiums Written. Net premiums written is the sum of direct premiums written and assumed premiums written less ceded premiums written. Ceded premiums written is the portion of our direct and assumed premiums that we transfer to our reinsurers in accordance with the terms of our reinsurance contracts based upon the risks they accept. See Note 7 to our audited consolidated financial statements included in this prospectus. We use net premiums written, primarily in relation to gross premiums written, to measure the amount of business retained after cessions to reinsurers.

Gross Revenues (a non-GAAP financial measure). Gross revenues is the sum of gross premiums written plus all other revenues (finance income, commission and service fee income, net investment income and net realized gains (losses) on securities). We use gross revenues as the primary measure of the underlying growth of our revenue streams from period to period. Gross revenues are reconciled to total revenues in the

Loss Ratio. Loss ratio is the ratio (expressed as a percentage) of losses and loss adjustment expenses incurred to premiums earned and measures the underwriting profitability of a company s insurance business. Loss ratio generally is measured on both a gross (direct and assumed) and net (gross less ceded) basis. We use the gross loss ratio as a measure of the overall underwriting profitability of the insurance business we write and to assess the adequacy of our pricing. Our net loss ratio is meaningful in evaluating our financial results, which are net of ceded reinsurance, as reflected in our consolidated financial statements. Our loss ratios are generally calculated in the same way for GAAP and statutory accounting purposes.

Expense Ratio. Expense ratio is the ratio (expressed as a percentage) of net operating expenses to premiums earned and measures a company s operational efficiency in producing, underwriting and administering its insurance business. For statutory accounting purposes, operating expenses of an insurance company exclude investment expenses, and are reduced by other income. There is no such industry definition for determining an expense ratio for GAAP purposes. As a result, we apply the statutory definition to calculate our expense ratio on a GAAP basis. We reduce our operating expenses by ancillary income (excluding net investment income and realized gains (losses) on securities) to calculate our net operating expenses. Due to our historically high levels of reinsurance, we calculate our expense ratio on both a gross basis (before the effect of ceded reinsurance) and a net basis (after the effect of ceded reinsurance). Although the net basis is meaningful in evaluating our financial results that are net of ceded reinsurance, as reflected in our consolidated financial statements, we believe that the gross expense ratio better reflects the operational efficiency of the underlying business and is a better measure of future trends.

Combined Ratio. Combined ratio is the sum of the loss ratio and the expense ratio and measures a company s overall underwriting profit. If the combined ratio is at or above 100, an insurance company cannot be profitable without investment income (and may not be profitable if investment income is insufficient). We use the GAAP combined ratio in evaluating our overall underwriting profitability and as a measure for comparison of our profitability relative to the profitability of our competitors.

Ancillary Income Measures. We have developed measures of our ability to generate ancillary income that reflect the differences between our business model and those used by our competitors. We measure our ancillary income as a percentage of premiums earned and as a percentage of our operating expenses. We believe that most of our competitors only achieve point of sale contact through an independent agent and are therefore typically unable to generate significant amounts of ancillary income.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. As more information becomes known, these estimates and assumptions could change, thus having an impact on the amounts reported in the future. We view the estimates and assumptions used in establishing our reserves for losses and loss adjustment expenses and the estimates of future policy cancellations used in determining the amounts recorded as commissions and service fees and ceding commissions as our critical accounting policies.

Insurance Losses and Loss Adjustment Expense Reserves. Months and sometimes years may elapse between the occurrence of an automobile accident covered by one of our policies, reporting of the accident to us and our payment of the claim. We record a liability for estimates of losses that will be paid for accidents that have been reported to us, which we refer to in this prospectus as case reserves. In addition, since accidents are not always reported when they occur, we estimate liabilities for accidents that have occurred but have not been reported to us, which we refer to in this prospectus as incurred but not reported, or IBNR reserves.

We are directly liable for loss and loss adjustment expenses under the terms of the insurance policies our insurance subsidiaries underwrite. Each of our insurance subsidiaries establishes a reserve for all of its unpaid losses and loss adjustment expenses, including case and IBNR reserves, and estimates for the cost to settle the claims. We rely primarily on historical loss experience in determining reserve levels, on the assumption that

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historical loss experience provides a good indication of future loss experience. Our internal actuarial staff reviews our insurance subsidiaries reserves quarterly for each year on a state and coverage level. Quarterly reviews allow for timely adjustments to reserves based on additional information. As part of these quarterly reviews, our actuarial staff performs various tests to estimate ultimate average severity and frequency of claims. Severity represents the average cost per claim and frequency represents the number of claims per policy. As part of the overall review, the staff then evaluates loss and LAE ratios by accident year by state and by coverage for reasonableness. Estimation of LAE reserves is subject to variation as a result of factors such as inflation, claims settlement patterns, legislative activity and litigation trends. Also, we make key assumptions regarding future claims emergence, the number of claims to be closed in the future, the future impact of inflation, amounts that may be collected from subrogation or salvage and amount of claims that can be closed with or without payment. Changes in the assumptions we employ or our estimates associated with such assumptions could result in materially different amounts being reported as reserves. If necessary, we will increase or decrease the level of our reserves as experience develops or new information becomes known, in the period in which changes to the estimates are determined. Accordingly, the actual losses and loss adjustment expenses may differ materially from the estimates we have recorded. See Business Loss and Loss Adjustment Expense Reserves for additional information.

Effect of Future Cancellations. The insurance policies that we write, through our insurance subsidiaries and on behalf of other insurers for which we receive a commission, are subject to being cancelled by the policyholder prior to the policy expiration date. As a result, we estimate the effect of future cancellations in determining the amount of commission and service fee income and ceding commissions that are recorded in our consolidated financial statements. We use historical cancellation rates that are updated quarterly to estimate future cancellations with the effect of any changes in our estimates being recorded in the period in which the change in the estimate is determined to be necessary. However, actual cancellations may differ materially from the cancellation estimates that we used. As of December 31, 2003, the reserve for return of commission and service fee income and return of ceding commissions was $4.9 million and $3.1 million, respectively.

Allowance for Finance Receivable Losses. Losses on finance receivables include an estimate of future credit losses on premium finance accounts. Credit losses on premium finance accounts occur when the unearned premiums received from the insurer upon cancellation of a financed policy are inadequate to pay the balance of the premium finance account. The majority of these shortfalls result in the write-off of unrealized interest and premium finance acquisition fees. We review historical trends of such losses relative to finance receivable balances to develop estimates of future losses. However, actual write-offs may differ materially from the write-off estimates that we used. As of December 31, 2003, the allowance for finance receivable losses was $5.9 million.

See Note 1 to our audited consolidated financial statements included in this prospectus for a discussion of our other significant accounting polices.

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Results of Operations

The table below summarizes certain operating results and key measures we use in monitoring and evaluating our operations. The information provided is intended to summarize and supplement information contained in our consolidated financial statements and to assist the reader in gaining a better understanding of our results of operations.

	Year Ended December 31,		
	2003	2002	2001
	($ in millions)		
Selected Financial Data			
Gross premiums written	$ 435.2	$ 335.2	$ 238.7
Ancillary income	78.5	62.9	49.4
Net investment income	10.1	5.2	7.3
Gross revenues	$ 523.8	$ 403.3	$ 295.4
Ceded premiums written	(140.1)	(154.2)	(125.8)
Change in net unearned premiums	(66.6)	(36.0)	(14.9)
Total revenues	$ 317.1	$ 213.1	$ 154.7
Net income	$ 43.1	$ 31.0	$ 0.4
Net income adjusted for write-off of reinsurance recoverables from Reliance Insurance Company(1)	$ 43.1	$ 31.0	$ 7.8
Key Financial Ratios			
Loss ratio net	73.6%	69.4%	95.8%
Expense ratio net	1.1	2.1	12.3
Combined ratio net	74.7	71.5	108.1
Ancillary income to gross premiums earned	19.9	22.1	23.8
Ancillary income to net operating expenses	97.0	95.4	80.3

(1) Amounts adjusted for the $7.4 million after-tax effect of the write-off in 2001 of reinsurance balances recoverable from Reliance Insurance Company. If we exclude the impact of the write-off, the 2001 net loss ratio, net expense ratio and net combined ratio would have been 84.3%, 12.6% and 96.9%, respectively. We consider net income adjusted for the write-off of reinsurance recoverables from Reliance Insurance Company and the adjusted net loss, net expense and net combined ratios to be non-GAAP financial measures. Because we have not had any other material write-offs of reinsurance recoverables in our history, we believe that the adjusted net income and the corresponding adjusted net loss, net expense and net combined ratios are useful to management and investors in understanding our improvement in operating results from 2001 to 2003. Reconciliations of the adjusted net income and the adjusted ratios are provided in Management s Discussion and Analysis of Financial Condition and Results of Operations Overview of Operating Results .

Overview of Operating Results

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Net income increased to $43.1 million in 2003 from $31.0 million in 2002. The increase in net income was primarily attributable to an increase in premium volume that provided additional underwriting income and growth in ancillary income, both of which were partially offset by an increase in operating expenses. Our loss ratio in 2003 was 73.6% compared to a 69.4% loss ratio in 2002. The impact of loss reserve development was insignificant to our 2003 loss ratio; however, our 2002 loss ratio was decreased by approximately 4.4 points due to the combined impact of favorable development on prior year reserves and a gain on the commutation of obligations of one of our reinsurers. Ancillary income increased to $78.5 million in 2003 from $62.9 million in 2002, which was

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sufficient to offset all but $2.4 million and $3.0 million of operating expenses in 2003 and 2002, respectively. During 2003, we realized net gains on securities and other of $3.4 million as compared to a net realized loss of $0.1 million in 2002.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Net income was $31.0 million in 2002, compared to net income of $0.4 million in 2001. The increase in net income from 2001 was primarily attributable to improved underwriting results from decreasing loss ratios, an increase in premium volume that provided additional underwriting margins and related ancillary income, and the impact of the write-off of reinsurance recoverable from Reliance in 2001. Our loss ratio in 2002 improved by 26.4 points to 69.4% compared to a 95.8% loss ratio in 2001. The 2002 loss ratio was favorably impacted by 2.6 points due to favorable development of prior year reserves and by 1.8 points attributable to a gain on the commutation of prior year obligations of one of our reinsurers. Our 2001 loss ratio was adversely impacted by 11.5 points as a result of the write-off of recoverables from Reliance and an additional 1.3 points of adverse development of prior year reserves.

Our results improved during 2002 in virtually every state in which we operate, with the most significant improvement occurring in Florida, where our net loss ratio improved from approximately 98% in 2001 to 68% in 2002. On a direct basis, which excludes the impact of reinsurance including the commutation in 2002 and the Reliance Insurance Company write-off in 2001, the Florida loss ratio improved from approximately 92% in 2001 to 71% in 2002. This improvement resulted from the impact of rate increases, strengthened claims procedures and fraud detection practices, and improved underwriting standards. In addition, in response to the September 2000 grand jury report on the level of fraud in Florida s mandatory PIP coverage, the Florida legislature enacted new laws in July and October 2001 designed to deter insurance fraud by delaying the availability of accident reports, requiring the registration of medical clinics, and improving companies rights to investigate suspicious claims.

We believe that the discussion about the write-off of reinsurance recoverables from Reliance Insurance Company provided below is useful to management and investors in understanding the comparability of results between 2003, 2002 and 2001 because we have not had any other material write-offs of reinsurance recoverables in our history. In 2001, our results were adversely impacted by a write-off of $11.1 million, $7.4 million after taxes, in reinsurance recoverables from Reliance Insurance Company. Reliance Insurance Company was one of the reinsurers in our quota share reinsurance program from October 1996 to December 2000. Due to a rapid and significant deterioration in Reliance Insurance Company s underwriting results, adverse development on its loss reserves, and liquidity issues that arose after the terrorist attacks on September 11, 2001, Reliance Insurance

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Company was placed into liquidation by the Pennsylvania Department of Insurance in October 2001. The table provided below reconciles net income to net income adjusted for the write-off of reinsurance recoverables from Reliance Insurance Company (which is a non-GAAP financial measure). The table below reflects the impact of the write-off on each line item affected on our Statement of Operations for the year ended December 31, 2001 and certain key financial ratios (all of which are non-GAAP financial measures).

	December 31, 2001	Impact of Reliance Write-off	Adjusted December 31, 2001
		($ in millions)	
Premiums earned	$ 98.0	$ 1.4	$ 99.4
Total revenues	154.7	1.4	156.1
Insurance losses and loss adjustment expenses	93.9	(10.1)	83.8
Selling, general and administrative costs	53.9	0.4	54.3
Total expenses	155.4	(9.7)	145.7
Income (loss) before income taxes	(0.7)	11.1	10.4
Income tax expense (benefit)	(1.1)	3.7	2.6
Net income	$ 0.4	$ 7.4	$ 7.8
Loss ratio net	95.8%	(11.5)%	84.3%
Expense ratio net	12.3	0.3	12.6
Combined ratio net	108.1	(11.2)	96.9

Revenues

Premiums

Premiums include non-standard personal automobile insurance premiums and term life insurance premiums underwritten by our insurance subsidiaries (which we refer to in this prospectus as direct premiums) and a percentage of non-standard personal automobile insurance premiums assumed from other insurers generally in states where we do not currently have a licensed insurance subsidiary (which we refer to in this prospectus as assumed premiums). We refer to direct and assumed premiums together as gross premiums. We manage virtually every aspect of the assumed business, including pricing and underwriting, claims settlement and customer service. We currently assume a significant portion of non-standard personal automobile insurance premiums for business produced in North Carolina and Texas.

Premiums written refers to the total amount of premiums billed to the policyholder less the amount of premiums returned, generally as a result of cancellations, during a given period. Premiums written become premiums earned as the policy ages. Barring premium rate changes, if an insurance company writes the same mix of business each year, premiums written and premiums earned will be equal, and the unearned premium reserve will remain constant. During periods of growth, the unearned premium reserve will increase, causing premiums earned to be less than premiums written. Conversely, during periods of decline, the unearned premium reserve will decrease, causing premiums earned to be greater than premiums written.

We have historically relied on quota share, excess of loss, and catastrophe reinsurance primarily to manage our regulatory capital requirements and also to limit our exposure to loss. Generally, we have ceded a significant portion of our non-standard automobile insurance premiums to unaffiliated reinsurers in order to maintain a net premiums written to statutory surplus ratio of approximately 3 to 1. We retain 100% of our term life insurance premiums.

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The following table presents our gross premiums written in our major markets and provides a summary of gross, ceded and net premiums written and earned for the periods indicated.

	Year Ended December 31,		
	2003	2002	2001
	($ in millions)		
Gross premiums written			
Florida	$ 223.5	$ 174.3	$ 110.2
Tennessee	63.0	58.6	42.6
Georgia	32.2	30.4	31.0
Louisiana	31.3	23.8	18.4
Mississippi	22.3	18.8	17.8
Texas	15.6		
All other states	47.3	29.3	18.7
Gross premiums written	$ 435.2	$ 335.2	$ 238.7
Ceded premiums written	(140.1)	(154.2)	(125.8)
Net premiums written	$ 295.1	$ 181.0	$ 112.9
Gross premiums earned	$ 394.9	$ 284.3	$ 207.2
Ceded premiums earned	(166.4)	(139.3)	(109.2)
Net premiums earned	$ 228.5	$ 145.0	$ 98.0
Net premiums written to gross premiums written	67.8%	54.0%	47.3%
Gross premiums earned to gross premiums written	90.7	84.8	86.8
Net premiums earned to net premiums written	77.4	80.1	86.8

Gross Premiums

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Gross premiums written increased $100.0 million or 29.8% to $435.2 million in 2003 from $335.2 million in 2002. The majority of our growth occurred in our largest state, Florida, which represented 51.4% of our business and accounted for $49.2 million of the increase. Approximately 80% of the growth in Florida was attributable to an increase in average policies inforce, including an increase in the number of renewal policies, with the remaining 20% coming from an increase in the average premiums per policy. In January 2003, we began our expansion into the state of Texas and are assuming non-standard personal automobile insurance policies underwritten by a Texas county mutual insurer. We assumed $15.6 million of gross premiums written in Texas during 2003. The majority of the increases in gross premiums written in our other states were due primarily to increased market penetration. Gross premiums earned, a function of gross premiums written over the current and prior periods, increased to $394.9 million in 2003 from $284.3 million in 2002.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Gross premiums written increased $96.5 million or 40.4% in 2002 compared to 2001, while gross premiums earned increased $77.1 million or 37.2%. These increases were primarily due to increased market penetration and an increase in average policy premiums. During 2002, average inforce policies increased 19.3%, while the average premium per policy inforce increased 11.4% compared to 2001. The majority of this growth occurred in the states of Florida and Tennessee, which accounted for $80.1 million or 83.0% of the growth in gross premium written in 2002.

Net Premiums

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Net premiums written increased 63.0% to $295.1 million in 2003 from $181.0 million in 2002. The ratio of net premiums written to gross premiums written increased to 67.8% in 2003 from 54.0% in 2002 as the increased capitalization of our

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insurance subsidiaries enabled us to reduce our ceding percentage and retain more business. Net premiums earned, a function of net premiums written over the current and prior periods, amounted to $228.5 million and equaled 77.4% of net premiums written. This percentage is lower than the relationship of gross premiums earned to gross premiums written of 90.7% since the majority of the increase in business retained did not occur until the third and fourth quarters of 2003.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Net premiums written for 2002 were $181.0 million, an increase of 60.3%. Net premiums written were 54.0% of gross premiums written, compared to 47.3% for 2001, reflecting a change in reinsurance agreements that resulted in a decrease in the percentage of business ceded during 2002. Net premiums earned, a function of net premiums written for 2002, amounted to $145.0 million and constituted 80.1% of net premiums written, which is comparable to the relationship of gross premiums earned to gross premiums written of 84.8%.

Ancillary Income

Ancillary income includes finance income, commission and service fee income and other income. Finance income primarily consists of interest, acquisition and service fees, and delinquency fees on the premium finance agreements related to the insurance policies we finance. Our agency and administrative subsidiaries produce and service non-standard personal automobile insurance business for other insurers from which we assume a portion of this business, and in some cases the entire premium, through reinsurance treaties. We receive service fees for agency, underwriting, policy administration, and claims adjusting services performed on behalf of these unaffiliated insurers. We also receive commission and service fee income on other insurance products produced for unaffiliated insurance companies on which we do not bear underwriting risk, including travel protection, vehicle protection and hospital indemnity insurance policies. Our business model allows us to generate a significant amount of ancillary income, which we measure as a percentage of gross earned premiums and as a percentage of our operating expenses. Our goal is to generate ancillary income in amounts that will exceed all of our operating expenses. The following table summarizes the components of our ancillary income for the periods indicated.

	Year Ended December 31,		
	2003	2002	2001
		($ in millions)	
Finance income	$ 44.9	$ 35.7	$ 27.3
Commission and service fee income	33.6	27.2	22.1
Total ancillary income	$ 78.5	$ 62.9	$ 49.4

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Ancillary income in 2003 increased 24.8% to $78.5 million from $62.9 million in 2002. This increase was primarily due to increased premium finance income as a result of higher premium volumes, increased sales of ancillary insurance products including business produced by the 42 Florida neighborhood sales offices acquired in November 2003 and increased service fee income related to the administration of our assumed business in Texas. The increase in premium finance income is net of an increase in the provision for finance receivable losses to $7.0 million in 2003 from $5.3 million in 2002. The majority of the increase in premium finance income is attributable to the increase in average gross premium finance receivables outstanding during the year. The allowance for credit losses remained at 2.9% of gross finance receivables in both 2003 and 2002. For the year ended December 31, 2003 and 2002, the ratio of ancillary income to gross premiums earned was 19.9% and 22.1%, respectively, and the ratio of ancillary income to operating expenses was 97.0% and 95.4%, respectively.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Ancillary income was $62.9 million in 2002, an increase of $13.5 million or 27.3% compared to 2001. This increase was primarily due to an increase in premium finance income as a result of increased premium volumes and increased penetration in the sales of ancillary insurance products. The increase in premium finance income also reflected a reduction in the allowance for credit losses as a percentage of finance receivables that resulted largely from the growth in the percentage of our business in Florida. This business experienced actual write-offs that were approximately

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38% and 50% better than the combined average of the other states in which we operated in 2002 and 2001, respectively. Additionally, the provision for finance receivable losses decreased slightly in 2002 because we experienced an overall reduction in the percentage of accounts canceling within the first two months from inception, which generally accounts for the majority of our write-offs. Ancillary income constituted 22.1% of gross premiums earned and 95.4% of our operating expenses for 2002 compared to 23.8% and 80.3% for 2001, respectively.

Net Investment Income

Our investment portfolio is generally highly liquid and consists substantially of readily marketable, investment-grade debt securities. Net investment income is primarily comprised of interest earned on these securities, net of related investment expenses.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Net investment income increased to $6.7 million in 2003 from $5.3 million in 2002 as a result of an increase in average invested assets that was partially offset by a decrease in the average yield on investments. Average invested assets increased 55.8% to $180.9 million in 2003 from $116.1 million in 2002 primarily as a result of the proceeds from our initial public offering, the majority of which were invested in the fourth quarter of 2003. The average investment yield decreased to 3.7% in 2003 from 4.4% in 2002 since a large portion of our portfolio was invested during the lower interest rate environment prevailing in 2003.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Net investment income increased to $5.3 million from $5.1 million in 2002 and 2001, respectively, due primarily to an increase in invested assets largely offset by a decrease in investment yields. Average invested assets grew 23.0% to $116.1 million in 2002 from $94.4 million in 2001. Our average investment yield for in 2002 was 4.4% compared to 4.5% for 2001.

Realized Gains (Losses) on Securities

Realized gains and losses on securities are principally affected by changes in interest rates, the timing of sales of investments and changes in credit quality of the securities we hold as investments.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Gross gains on debt securities for the year ended December 31, 2003 were $2.6 million, which were partially offset by gross losses of $0.6 million. Gross gains were primarily attributable to the sale of certain securities as we repositioned our bond portfolio based on our investment guidelines for changes in market conditions and other factors. Comparatively, in 2002, we realized gross gains on debt securities of $0.9 million that largely offset our gross losses of $1.0 million resulting from our investment in WorldCom, Inc. bonds. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities held in our portfolio as of the end of either period.

In 2003, we also realized gross gains of $2.7 million and gross losses of $0.9 million on closed contracts in our trading portfolio. The trading portfolio primarily consists of futures contracts, swaps, and other derivative instruments. This represents a speculative investment and does not represent a hedge; accordingly, all open contracts are marked to market with the change in market values included in net realized gains (losses) on securities and other in our consolidated statement of operations. For the year ended December 31, 2003, net realized gains (losses) on securities and other included a net loss of $0.4 million related to open contracts which included gross increases of $0.3 million and gross decreases of $0.7 million.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. We realized gross gains of $0.9 million and $2.4 million and gross losses of $1.0 million and $0.2 million on the sale of available for sale securities during 2002 and 2001, respectively. The gross losses in 2002 were primarily attributable to a loss on the sale of our investment in WorldCom bonds. In 2001, we took advantage of the declining interest rate environment and sold certain securities in our portfolio that generated $2.4 million in gains. There was no impact on realized losses attributable to adjustment for other than temporary impairment of securities still held during these periods. Based on our analysis, the securities that were determined to be impaired were sold

in the same period of the determination and the resulting loss was included in net realized gains or losses on securities.

Expenses

Insurance Losses and Loss Adjustment Expenses

Insurance losses and loss adjustment expenses represent our largest expense item and include payments made to settle claims, estimates for future claim payments and changes in those estimates for current and prior periods, as well as adjusting costs incurred in connection with settling claims. Insurance losses and loss adjustment expenses are influenced by claim frequency and severity trends, the impact of changes in estimates for prior accident years, and increases in the cost of medical treatment and automobile repairs. The anticipated impact of inflation is considered when we establish our premium rates and set loss reserves. We perform an actuarial analysis each quarter and establish or adjust (for prior accident quarters), our best estimate of the ultimate incurred losses and loss adjustment expenses to reflect loss development information and trends that have been updated for the most recent quarter s activity. Our estimate of ultimate loss and loss adjustment expenses is evaluated and re-evaluated by accident quarter, by state and by major coverage grouping (e.g., bodily injury, physical damage) and changes in estimates are reflected in the period the additional information becomes known.

Our reinsurance program significantly influences our net retained losses. In exchange for premiums ceded to reinsurers under quota share and excess of loss reinsurance agreements, our reinsurers assume a portion of the losses and loss adjustment expenses incurred. See Business Reinsurance . We remain obligated for amounts ceded in the event that the reinsurers do not meet their obligations under the agreements (due to, for example, disputes with the reinsurer or the reinsurer s insolvency). Since 2001, in an effort to manage the cost of quota share reinsurance during a period of rising cost and limited availability, we have added provisions for loss ratio corridors and loss ratio caps to our quota share reinsurance agreements that reduces the cost of reinsurance to us. These provisions have been structured to provide the reinsurers with some limit on the amount of potential loss being assumed, while maintaining the transfer of significant insurance risk with the possibility of a significant loss to the reinsurer, and therefore reduce the cost of reinsurance to us. Loss ratio corridors provide for layers of losses in which the reinsurer does not participate in the losses while loss ratio caps cut off the reinsurer s liability for losses above a specified loss ratio. We believe our reinsurance arrangements qualify for reinsurance accounting in accordance with SFAS 113 Accounting for Reinsurance Contracts .

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. For the year ended December 31, 2003, insurance losses and loss adjustment expenses increased to $168.2 million from $100.7 million in 2002, and the net loss ratio was 73.6% in 2003 compared to 69.4% in 2002. The 2003 insurance losses and loss adjustment expenses included $0.1 million in adverse development. Our 2002 results included $5.5 million in favorable development on prior years reserves that included $1.8 million related to a gain on the commutation of a reinsurer s obligations related to prior year reserves. The commutation also resulted in a $0.9 million gain related to current year obligations. Our loss ratios, excluding the impact of the commutation gains and adjustments to prior year s reserves, were 73.5% in 2003 and 73.8% in 2002. Catastrophic losses increased our annual loss ratios by approximately 0.6 points in 2003 and 0.3 points in 2002.

In 2003, the frequency and severity trends in the majority of our coverages remained relatively flat on a country-wide basis. We did note an increase in claims frequency in the Florida personal injury protection coverage, which we believe is generally attributable to increased fraud activity in the Miami market. We increased rates for personal injury protection coverages in October 2003 and noted a substantial reduction in new business in this market in November and December. Our special investigations unit is actively challenging those claims believed to be fraudulent. Overall, the gross accident year loss ratio for the Florida automobile book of business increased 1.7 points during 2003. The increase in the Florida gross accident year loss ratio was offset by lower accident year loss ratios in the majority of the states in which we operate, including Texas where our loss experience was below our countrywide average. Accident year loss ratios, as compared to the loss ratios included in our financial statements, include the impact of losses occurring within

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the current accident year and exclude the current year impact of any increase or decrease in losses and loss adjustment expenses related to losses that occurred in prior years.

Our reserve for loss and loss adjustment expenses as of December 31, 2003 was $112.6 million as estimated through our actuarial analysis. During the year, our actuarial analysis concluded that the December 31, 2002 reserve for loss and loss adjustment expenses of $86.9 million was generally adequate as the adverse reserve development for prior years reflected in the 2003 results was only $0.1 million.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Insurance losses and loss adjustment expenses increased to $100.7 million in 2002 from $93.9 million in 2001. Net loss ratios for 2002 and 2001 were 69.4% and 95.8%, respectively. Net loss ratios in 2002 improved in virtually every state in which we operate, reflecting the impact of increased rate levels, stabilized loss trends and favorable loss reserve development. We experienced favorable loss reserve development of $5.5 million in 2002, as compared to unfavorable development of $7.8 million in 2001. Included in the favorable reserve development in 2002 was $1.8 million attributable to the gain on the commutation of prior year obligations of one of our reinsurers. The commutation also resulted in a $0.9 million gain related to current year obligations. The favorable loss reserve development and the commutation gains resulted in an overall 4.4 point reduction in the 2002 net loss ratio. The $7.8 million unfavorable development in 2001 included $6.5 million of the $11.1 million write-off of reinsurance recoverables from Reliance that related to prior years. The unfavorable loss reserve development and write-off of reinsurance recoverables increased the 2001 net loss ratio by 12.9 points. Catastrophic losses increased our annual loss ratios by approximately 0.3 points in 2002 and 0.1 points in 2001.

Our reserve for loss and loss adjustment expenses as of December 31, 2002 was $86.9 million as estimated through our actuarial analysis. During the year, our actuarial analysis concluded that the December 31, 2001 reserve for loss and loss adjustment expenses of $77.5 million was redundant by approximately $5.5 million. Several factors contributed to this redundancy. We recognized a gain on the commutation of obligations of one of our reinsurers that resulted in $1.8 million of favorable development on prior years reserves. We also determined we had overestimated the frequency of bodily injury claims in Florida for the 2001 accident year based on trends that occurred in 1999 and 2000. During 2001, we implemented numerous changes to our claims processes and increased our claims staffing, which resulted in a quicker settlement process. We initially attributed the increase in claims paid in 2001 to a new frequency trend rather than the quicker settlement, which resulted in favorable reserve development of approximately $2.5 million. This overestimation of frequency also resulted in approximately $0.8 million of favorable development on our reserves for Florida personal injury protection claims. Finally, in 2001 we overestimated the severity of bodily injury losses in Georgia related to a regulatory change resulting in an increase in the minimum limits of coverage required by that state. As a result, our reserve for bodily injury losses in Georgia decreased by approximately $0.4 million.

Operating Expenses

Operating expenses include SGA costs, advertising and interest expense. These expenses include the amortization of policy acquisition and maintenance costs that are net of ceding commissions, costs associated with generating ancillary income and other revenues and corporate overhead. Our business model emphasizes the use of our largely fixed cost neighborhood sales offices staffed by company employees, which results in only marginal increases in operating expenses as we increase our premiums and other revenues.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002. Operating expenses increased 22.8% to $80.9 million for the year ended December 31, 2003 from $65.9 million in 2002. Excluding the effect of reinsurance commissions, operating expenses increased $9.7 million. The $9.7 million increase was primarily attributable to $3.6 million related to our expansion into Texas, $1.3 million in commission paid to our employee agents on the sale of ancillary insurance products and term life insurance, and other increases in operating costs primarily associated with increased premium volumes.

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001. Operating expenses increased $4.4 million or 7.2%, to $65.9 million in 2002, compared to $61.5 million in 2001. The increase was primarily attributable to a $5.5 million increase in commissions paid to an independent agency associated with

the increase in the volume of insurance produced for us, a $1.0 million increase related to our office expansion in the state of South Carolina and increases in other costs associated with increased premium volumes. These increases were partially offset by a $10.0 million increase in ceding commissions attributable to the increase in ceded premiums and a $1.4 million reduction in interest expense due to a the declining interest rate environment.

Income Taxes

We file a consolidated federal income tax return that includes all of our subsidiaries other than our life insurance subsidiary, which files a separate federal income tax return. The statutory rate used in calculating our tax provision was 35% in 2003 and 2002 compared to 34% in 2001. Our effective tax rates for the years ended December 31, 2003 and 2002 were 36.6% and 33.3%, respectively. Our effective tax rate has been increasing due to an increase in state income taxes, the elimination of the small life insurance company deduction, and a reduction in tax-exempt interest resulting from a decreased allocation of our investment portfolio to municipal securities. As our ancillary income has increased in our non-insurance subsidiaries, more of our income becomes subject to state income taxes. The provision for state income taxes increased our overall effective tax rate by 2.9 points in 2003, as compared to 1.0 point in 2002. In certain states, we are able to offset the state income taxes paid by our insurance subsidiaries against their provision for premium taxes.

Income tax expense (benefit) differed from the amounts computed at the statutory rate as demonstrated in the following table:

	Year Ended December 31,		
	2003	2002	2001
		($ in millions)	
Income (loss) before income taxes	$ 68.0	$ 46.5	$ (0.7)
Provision for taxes at the statutory rate	$ 23.8	$ 16.3	$ (0.2)
Increase (reduction) in taxes for:			
Tax-exempt interest income	(0.6)	(0.7)	(0.6)
Small life insurance company deduction		(0.5)	(0.6)
State income taxes	2.0	0.5	0.1
Other, net	(0.3)	(0.1)	0.2
Income tax expense (benefit)	$ 24.9	$ 15.5	$ (1.1)

Financial Condition

Liquidity and Capital Resources

Sources and Uses of Funds

We are organized as a holding company system with all of our operations being conducted by our wholly-owned insurance, premium finance, agency, administrative and consumer product subsidiaries. Accordingly, Direct General Corporation receives cash through loans from banks, issuance of equity securities, subsidiary dividends and other transactions. We may use the proceeds from these sources to contribute to the capital of our insurance subsidiaries and premium finance company in order to support premium growth, to repurchase our common stock, to retire our outstanding indebtedness, to pay interest, dividends, and taxes, and for other business purposes. We operate under an Intercompany Tax Allocation Agreement whereby our eligible subsidiaries compute tax provisions as if filing separate returns based on taxable income. Each subsidiary s resulting provision (or credit) will be currently payable to (or receivable from) Direct General Corporation.

Under state insurance laws, dividends, which must be paid from earned surplus, and capital distributions from our insurance companies are subject to restrictions relating to statutory surplus and earnings. Our insurance companies collectively paid dividends of $1.0 million, $1.3 million, and $2.1 million in 2003, 2002 and 2001, respectively. These dividends were generally reinvested in the capital of other insurance subsidiaries. Prior approval from state insurance regulatory authorities is generally required in order for our insurance

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companies to declare and pay extraordinary dividends to us. The maximum amount of dividend capacity available for payment to Direct General Corporation during the remainder of 2004 by our insurance subsidiaries without seeking regulatory approval is $10.5 million. Dividends from our premium finance subsidiary are limited by the minimum capital requirements in applicable state regulations and by covenants in our bank loan agreements, which require approval of our lenders. There are no restrictions on the payment of dividends from our agency, administrative and other non-insurance subsidiaries, other than typical state corporation law requirements to avoid insolvency. In addition, the NAIC Model Act for RBC provides formulas to determine the amount of capital that an insurance company needs to ensure that it has an acceptable expectation of not becoming financially impaired; a low RBC ratio would prevent an insurance company from paying dividends. At December 31, 2003, each of our insurance subsidiaries maintained an RBC level that is in excess of an amount that would require any corrective actions on our part.

Our operating subsidiaries primary sources of funds are premiums received, finance income, commission and service fee income, investment income, borrowings under credit facilities and proceeds from the sale and redemption of investments. Funds are used to pay claims and operating expenses, to pay interest and principal repayments under the terms of our indebtedness for borrowed money, to purchase investments and to pay dividends to Direct General Corporation. We had positive cash flow from operations of approximately $67.1 million in 2003, $52.4 million in 2002, and $45.5 million in 2001. We expect our cash flows to be positive in both the short-term and reasonably foreseeable future.

Financing and Capital

Initial Public Offering. In August 2003, we completed our initial public offering of 7,972,276 shares of common stock. We sold 3,750,000 shares and selling shareholders sold 4,222,276 shares resulting in net proceeds to us (after deducting issuance costs) of approximately $71.6 million. In conjunction with the offering of common stock, all outstanding shares of preferred stock were converted into common stock and we received an additional $0.8 million from the exercise of a common stock warrant. We used $51.9 million of the proceeds to increase our investment in our insurance subsidiaries and $0.6 million to increase the capitalization of our non-insurance subsidiaries. In addition, we used $7.7 million of the proceeds to pay off a term loan with two banks. The remaining proceeds have not been permanently deployed to date and generally have been used to reduce the amount outstanding under the premium finance revolving credit facility described below. During 2004, we anticipate using the remainder of these proceeds to further increase the capital in our insurance subsidiaries and for general corporate purposes.

Premium Finance Revolving Credit Facility. Our premium finance operations are supported by a revolving credit agreement with a group of banks. The size of the facility was $190.0 million at December 31, 2003, and is periodically increased to support the growth in premiums we finance. We would expect to continue this practice with our group of banks. There is the risk that our attempt to increase this revolving credit line facility would not be successful, in which case we would be forced to seek alternative methods of financing premiums.

Our premium finance subsidiary utilizes the revolving credit facility by drawing on the facility at the end of every month to settle amounts due to the insurance companies. As payments from our customers are received, the revolving credit facility is reduced over the course of the month. This cycle repeats itself monthly, with historically, some seasonal fluctuation on total amounts drawn at the end of each month.

Amounts outstanding under this facility were $148.0 million and $115.0 million as of December 31, 2003 and 2002, respectively. Interest on the facility is payable quarterly and all outstanding advances and accrued interest are due on or before June 30, 2004. Based upon communications with our lenders, we expect our premium finance revolving credit facility to be renewed for an additional two year period. The amount and terms of the credit facility have not been negotiated, but we do not anticipate that the terms will change materially. The weighted average interest rate in effect was 3.4% in 2003 and 4.6% in 2002. The loan is principally secured by our finance receivables of the premium finance subsidiary and is guaranteed by Direct General Corporation. See Note 6 to our audited consolidated financial statements included in this prospectus for further discussion regarding our current outstanding debt.

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In an effort to manage our interest rate risk related to our premium finance revolving credit agreement, effective November 1, 2001, we purchased a derivative instrument known as a zero-cost collar from Bank One, NA. This derivative instrument requires monthly settlements whereby we pay the difference to the extent the then current 30-day LIBOR rate is below the floor of 5.05% on $25 million and receive the excess of the 30-day LIBOR rate over the cap of 5.05% on $50 million. This derivative instrument was designed to reduce our exposure to changes in LIBOR under our bank loan facilities. Since interest rates are below 5.05% (30-day LIBOR was 1.17% at December 31, 2003), the fair market value of this derivative instrument is unfavorable to us and, accordingly, we recorded a liability of $1.4 million at December 31, 2003. This unrealized loss is reported as a separate component of shareholders equity on an after-tax basis. Payments associated with the floor were $1.0 million, $0.8 million and $0.1 million for the years ended December 31, 2003, 2002 and 2001, respectively, and were reported in the income statement as interest expense. This derivative instrument is scheduled to terminate on November 1, 2005. See Note 12 to our audited consolidated financial statements included in this prospectus for further discussion on this derivative instrument.

For the year ended December 31, 2003, we received net proceeds from the issuance of common stock of $72.5 million and increased our borrowings on the premium finance revolving credit facility by $33.0 million. During the year, we repaid all outstanding principal under our term loans totaling $10.2 million, paid interest on outstanding indebtedness of $5.3 million, interest on the Series A redeemable preferred stock of $0.3 million, dividends on the Series B preferred stock of $0.3 million, and dividends on common stock of $0.9 million. The Series A redeemable preferred stock and Series B preferred stock were converted to common stock in connection with our initial public offering in August 2003.

For the year ended December 31, 2002, we received net proceeds from borrowings on capital loans of $1.2 million and borrowings on the premium finance revolving credit facility of $18.9 million, repurchased 1,328,364 shares of our Treasury stock at a total cost of $4.5 million (average of $3.42 per share), paid interest on outstanding indebtedness of $6.2 million, interest on the Series A redeemable preferred stock of $0.5 million, and dividends on the Series B preferred stock of $0.6 million.

For the year ended December 31, 2001, we repaid $6.0 million of principal on our capital loan, received $18.4 million in net proceeds from borrowings under the premium finance revolving credit facility, paid interest on outstanding indebtedness of $7.7 million, dividends on the Series A redeemable preferred stock totaling $0.5 million and dividends on the Series B preferred stock of $0.6 million.

Contractual Obligations. The following table summarizes our contractual obligations as of December 31, 2003.

	Payments due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
	($ in millions)				
Premium finance revolving credit facility	$ 150.5	$ 150.5	$	$	$
Capital leases obligations	5.2	1.4	3.6	0.2	
Operating leases obligations	16.2	7.2	8.1	0.9	
Other long-term debt	1.0	0.6	0.4		
Total	$ 172.9	$ 159.7	$ 12.1	$ 1.1	$

Reinsurance

We have historically operated with a limited amount of capital and, as a result, have extensively used the reinsurance market to maintain our net exposures within our capital resources. We cede premiums and losses to unaffiliated insurance companies under quota share, excess of loss and catastrophe reinsurance agreements. We evaluate the financial condition of our reinsurers and monitor various credit risks to minimize our exposure to losses from reinsurer insolvencies. However, we remain obligated for amounts ceded in the event that the reinsurers do not meet their obligations. Because we cede a high percentage of our premiums and the associated losses, a failure of one of our reinsurers to pay could have a significant adverse effect on our capital

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and our financial condition and results of operations. In 2001, one of our reinsurers, Reliance, was declared insolvent and, as a result, we wrote off reinsurance recoverables of $11.1 million. See Management s Discussion and Analysis of Financial Condition and Results of Operations Overview of Operating Results .

Over the past few years, we have implemented several changes to our reinsurance program designed to reduce our exposures to unsecured reinsurance recoverables, including changing the settlement of reinsurance premiums to an earned basis versus a written basis, requiring reinsurers to fund a trust account in the event of a rating downgrade by A.M. Best, and limiting the maximum participation by any one reinsurer. As a result, the amount of unsecured reinsurance recoverables at December 31, 2003 was reduced to 18.4% of shareholders equity or $32.7 million from 53.0% of shareholders equity or $31.4 million at December 31, 2002. In addition, the largest unsecured recoverable from a single reinsurer was $9.2 million at December 31, 2003. This same amount was due from both National Union Fire Insurance Company of Pittsburgh, PA, a subsidiary of American International Group, Inc., and Swiss Re America, which are rated A++ (Superior) and A+ (Superior) , respectively, by A.M. Best.

Investments

We had total cash, cash equivalents and invested assets of $353.6 million as of December 31, 2003. The following table summarizes our cash, cash equivalents and invested assets as of the dates indicated.

	Amortized Cost	Fair Value	% of Total at Fair Value
		($ in millions)	
December 31, 2003			
Debt securities, available for sale	$ 263.9	$ 265.0	74.9%
Cash and cash equivalents	87.3	87.3	24.7%
Short-term investments	1.3	1.3	0.4%
Total	$ 352.5	$ 353.6	100.0%
December 31, 2002			
Debt securities, available for sale	$ 119.3	$ 123.6	57.9%
Cash and cash equivalents	87.0	87.0	40.8%
Short-term investments	2.7	2.7	1.3%
Total	$ 209.0	$ 213.3	100.0%

Investment Strategy. We believe that our investment portfolio is highly liquid and consists substantially of readily marketable, investment-grade debt securities. We currently do not invest in equity securities or securities with exposure to foreign currency risk. Effective April 1, 2003, Bank One Investment Advisors and U.S. Bancorp Asset Management provide our investment portfolio management advisory services. Prior to March 31, 2003, our investment advisors were Deutsche Asset Management. These advisors operate under investment guidelines approved by our investment committee. These guidelines emphasize:

- preservation of capital with a focus on total return,
- achieving the highest risk adjusted after tax return and
- diversification in order to reduce risk.

Our investment strategy recognizes our need to maintain capital adequate to support our insurance operations. Our investment objectives also include maximizing the benefit from premium tax credits. Certain of the states in which we do business provide relief from premium taxes to the extent we maintain qualifying investments in those states and their municipalities. As a result, historically a significant amount of debt

securities in our portfolio were comprised of tax-exempt obligations of the states of Louisiana, Mississippi and

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Tennessee, in order to maximize these premium tax credits. Additionally, we invested in tax-exempt obligations of Georgia prior to 2003.

Our investment guidelines also permit us to invest up to 2% of the fair value of our investment portfolio in alternative investments, including commodities. Within those guidelines, we invested $1.0 million in September 2002 in a managed trading account with a commodities trading company. Net realized gains from the trading activities were reinvested and the fair value of this account was $2.6 million as of December 31, 2003. This investment represents less than 1% of our entire investment portfolio. Generally, only 15% of the account balance is invested in commodities and related investments and the remaining portion of the account balance is held in cash, cash equivalents and U.S. Treasury obligations. Because this is a margin account, the ultimate losses generated by this investment may greatly exceed the portion of the account balance so invested. However, we reduce the risk of margin call by limiting our investment to 15% of the account balance. In addition, we closely monitor the performance of the account in an effort to reduce the risk of losses. During 2003, we realized gross gains of $2.7 million and gross losses of $0.9 million on closed contracts in our trading portfolio. Since the trading portfolio, which primarily consists of futures contracts, swaps, and other derivative instruments, represents a speculative investment and does not represent a hedge, all open contracts are marked to market with the change in market values included in net realized gains (losses) on securities and other in our consolidated statement of operations. For the year ended December 31, 2003, net realized gains (losses) on securities and other included a net loss of $0.4 million related to open contracts which included gross increases of $0.3 million and gross decreases of $0.7 million.

Debt Securities. Our investment portfolio consists primarily of debt securities, all of which are classified as available for sale and are carried at fair value with unrealized gains and losses reported in our financial statements as a separate component of shareholders equity on an after-tax basis. As of December 31, 2003, the fair value of our investment portfolio of $265.0 million included $1.1 million in pretax net unrealized gains. As of December 31, 2002, the fair value of our investment portfolio of $123.6 million included $4.3 million in pretax net unrealized gains. The increase in net unrealized gains during 2002 was attributable to the declining interest rate environment.

We realized pretax net gains on the sale of securities of $2.0 million in 2003. Comparatively, we realized pretax net losses of $0.1 million in 2002, which was comprised of a $1.0 million loss on our investment in WorldCom bonds that was almost entirely offset by gains on the sale of other debt securities. Net realized gains on securities available for sale were $2.2 million in 2001. The weighted average book yield of the portfolio was 3.7% for the year ended December 31, 2003, 4.4% for 2002 and 4.5% for 2001. The effective duration of our investment portfolio was 3.3 years at December 31, 2003, compared to 3.8 years at December 31, 2002.

We monitor our investment results by comparing the total return on our portfolio of debt securities to the total return for a customized benchmark based on a blend of Lehman indices. Total return is comprised of interest income and the change in the fair value of the securities. Prior to 2003, we did not manage our investment returns by individual asset class because one of our primary investment objectives was to maximize the premium tax credits available to us by investing a significant portion of our portfolio in the municipal obligations of Tennessee, Louisiana, Mississippi and Georgia. In 2003, we changed investment advisors, divided the portfolio management between two firms, and, in an effort to increase the overall yield of the portfolio, liquidated our investment in tax-exempt obligations of Georgia. In conjunction with these changes, we now separately evaluate the total return of our taxable and tax-exempt securities by comparing them to customized benchmarks for each investment class. The total return on our portfolio of debt securities was 3.7% for the year ended December 31, 2003, 8.5% in 2002 and 6.5% in 2001.

The following table presents the composition by our internal industry classification of the amortized cost, gross unrealized gains, gross unrealized losses and fair value of debt securities in our investment portfolio as of the dates indicated.

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	($ in millions)			
December 31, 2003				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 94.8	$ 0.3	$ 1.1	$ 94.0
Obligations of states and political subdivisions	49.9	1.8		51.7
Corporate debt securities				
Banks and financial institutions	41.7	0.4	0.4	41.7
Credit cards and auto loans	37.7	0.3	0.2	37.8
Industrial	23.8	0.3	0.3	23.8
Telecommunications	9.6	0.1	0.1	9.6
Utilities	6.4	0.1	0.1	6.4
Total corporate debt securities	119.2	1.2	1.1	119.3
Total	$ 263.9	$ 3.3	$ 2.2	$ 265.0
December 31, 2002				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 16.4	$ 0.6		$ 17.0
Obligations of states and political subdivisions	69.6	2.5		72.1
Corporate debt securities				
Banks and financial institutions	10.4	0.4		10.8
Credit cards and auto loans	9.8	0.3		10.1
Industrial	9.0	0.4		9.4
Telecommunications	2.1	0.1		2.2
Utilities	2.0			2.0
Total corporate debt securities	33.3	1.2		34.5
Total	$ 119.3	$ 4.3		$ 123.6

The amortized cost and fair value of debt securities in our investment portfolio as of December 31, 2003, by contractual maturity, is shown below.

	Amortized Cost	Fair Value
	($ in millions)	
Years to maturity:		
One or less	$ 9.9	$ 9.9
After one through five	136.8	137.5
After five through ten	91.4	91.8
After ten	25.8	25.8
Total	$ 263.9	$ 265.0

The Securities Valuation Office of the NAIC evaluates the bond investments of insurers for regulatory reporting purposes and assigns securities to one of six investment categories called NAIC designations . The NAIC designations generally parallel the credit ratings of the nationally recognized statistical rating organizations for marketable bonds. NAIC designations 1 and 2 include bonds considered to be investment

grade, which are those rated BBB or higher by Standard & Poor s, a division of The McGraw-Hill Companies, Inc. NAIC designations 3 through 6 include bonds considered to be below investment grade, rated BB+ or lower by S&P. All of the debt securities in our portfolio were rated investment grade by the NAIC and S&P as of December 31, 2003. Investment grade securities generally bear lower yields and lower degrees of risk than those that are unrated or are rated non-investment grade. The quality distribution of our investment portfolio as of December 31, 2003 was as follows:

S&P Rating	NAIC Rating	Amortized Cost	Fair Value	% of Total at Fair Value
			($ in millions)	
AAA	1	$ 140.7	$ 140.9	53.2%
AA	1	29.9	30.6	11.5%
A	1	45.1	45.3	17.1%
BBB	2	24.1	24.1	9.1%
Agency	1	24.1	24.1	9.1%
		$ 263.9	$ 265.0	100.0%

We evaluate the risk versus reward tradeoffs of investment opportunities, measuring their effects on the stability, diversity, overall quality and liquidity of our investment portfolio. The primary market risk exposure to our debt securities portfolio is interest rate risk, which we strive to limit by managing duration to a defined range of three to four years. Interest rate risk includes the risk from movements in the underlying market rate and in credit spreads of the respective sectors of debt securities held in our portfolio. The fair value of our fixed maturity portfolio is directly impacted by changes in market interest rates.

As of December 31, 2003, the impact of an immediate 100 basis point increase in market interest rates on our debt securities portfolio would have resulted in an estimated decrease in fair value of 4.1%, or approximately $10.9 million. As of the same date, the impact of an immediate 100 basis point decrease in market interest rates on our debt securities portfolio would have resulted in an estimated increase in fair value of 4.1%, or approximately $10.8 million.

An additional exposure to our debt securities portfolio is credit risk. Our ability to manage credit risk is essential to our business and our profitability. We attempt to manage our credit risk through issuer and industry diversification. Our investment committee establishes our investment guidelines and supervises our investment activity. It regularly monitors our overall investment results, reviews compliance with our investment objectives and guidelines, and ultimately reports our overall investment results to our board of directors. Our investment guidelines include limitations on the minimum rating of debt securities in our investment portfolio as well as restrictions on investments in debt securities of a single issuer.

On a quarterly basis, we examine our investment portfolio for evidence of impairment. The assessment of whether such impairment has occurred is based on management s evaluation, on an individual security basis, of the underlying reasons for the decline in fair value. In such cases, changes in fair value are discussed with our investment advisors and evaluated to determine the extent to which such changes are attributable to interest rates, market-related factors other than interest rates, as well as financial conditions, business prospects and other fundamental factors specific to the issuer. Declines attributable to issuer fundamentals are reviewed in further detail. When one of our securities has a decline in fair value that is determined to be other than temporary, we reduce the carrying value of such security to its current fair value as required by GAAP.

Based upon our analysis, we believe that we will recover all contractual principal and interest payments related to those securities that currently reflect unrealized losses and that we have the ability to hold these securities until they mature or recover in value. Should either of these beliefs change with regard to a particular security, a charge for impairment would likely be required. While it is not possible to accurately predict if or when a specific security will become impaired, charges for other than temporary impairment could be material to our results of operations in a future period. Management believes it is not likely that future impairment charges will have a significant effect on our liquidity.

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As of December 31, 2003, investments carried at fair value of $8.2 million and approximately $0.1 million of cash were on deposit with state insurance regulatory authorities. Additionally, investments carried at fair value of $3.8 million and cash of $4.0 million had been pledged to secure letters of credit in connection with our reinsurance obligations.

Cash and Cash Equivalents. Our balance in cash and cash equivalents was $87.3 million and $87.0 million as of December 31, 2003 and 2002, respectively.

Short-Term Investments. Our short-term investments primarily consist of investments in commercial paper, other interest-bearing time deposits with original maturities from three months to one year and our managed commodities trading account.

2004 Outlook

Growth. We expect our gross revenues to increase between 15% and 20% annually over the next 5 years through additional market penetration in many of our existing states and the opportunities that we believe we have to expand into other markets. However, during 2004 we expect that gross revenues will grow in excess of 20%. We anticipate continued overall growth in our existing markets as a result of increasing renewal of policies, modest additional market penetration and an increase in ancillary products and term life premiums that we expect to be produced by the 42 Florida neighborhood sales offices that we acquired in November 2003. In addition, we are continuing our expansion into the state of Texas through a relationship with an independent agency network. We have obtained an option to acquire the assets of this Texas network at the end of 2004. We also expect to begin developing up to 20 of our own neighborhood sales offices in areas of Texas where we believe additional market presence is needed to supplement the independent agency network. Based upon existing market conditions, we currently estimate gross premiums written in Texas will be approximately $40 million in 2004 and could be as much as $80 to $90 million in 2005, assuming that we exercise our option to acquire the Texas agency network and successfully integrate its operations. We also plan to commence our initial expansion into Missouri during the second half of 2004 with the development of up to 20 of our own neighborhood sales offices. We continue to evaluate our expansion opportunities into other states and currently expect to begin expansion into Virginia in 2005 through the opening of neighborhood sales offices. We are continually looking for expansion opportunities through organic growth and through the acquisition of independent agency networks. As a result, future expansion states may change from time to time depending on the opportunities that are presented and possible changes in market conditions.

Cash Register Agency Acquisition. Effective November 1, 2003, we purchased the assets of Cash Register, a 42-office independent agency network, for $13.8 million. The assets acquired primarily consisted of intangible assets recorded as goodwill. Cash Register had been producing business for us as an agent in Florida since 1999 and produced approximately $87 million of non-standard personal automobile insurance premiums for us in the first ten months of 2003. Prior to our acquisition, this agency did not produce term life insurance business for us, and the commission income generated from the sale of ancillary products remained with the agency. As a result of the acquisition, the majority of the agency s employees became our salaried employees and we assumed the operating leases of most the neighborhood sales offices. We believe that we will benefit from this acquisition by receiving the commission income generated on the sale of ancillary products, increasing the distribution of our term life insurance product, and converting the cost structure from a variable structure with commissioned independent agents to a largely fixed cost structure provided by our business model.

During November and December 2003, after the completion of the acquisition, the 42 sales offices acquired from the Cash Register agency network generated commission and administrative fee income of $0.8 million and term life insurance premiums of $0.3 million for us. Based upon historical trends of our neighborhood sales offices and the trends of the sales offices acquired from Cash Register, we estimate that the former Cash Register sales offices could contribute between $6 million and $10 million of additional gross revenues from term life insurance premiums, and commission and service fee income on the sales of ancillary products in 2004.

During 2003, the cost of operating our neighborhood sales offices in Florida was approximately $17,000 per office per month or $14,000 per office per month excluding advertising costs, which operating costs represented 11% and 9% of gross premiums written, respectively. In comparison, prior to the acquisition, our commission expense incurred less service fees earned related to the Cash Register offices was $16.9 million or 19.5% of gross premiums written by the agency. Since the acquisition, the average monthly operating costs per office (excluding advertising costs) for the former Cash Register offices was approximately $14,000 or 9% of the gross premiums written produced by those offices. Assuming that the average monthly operating costs per office of the former Cash Register offices remain at levels that are consistent with the historical operating costs per office of our Florida neighborhood sales offices, we estimate that operating expense savings could range from $6 million to $9 million, excluding the effects of the capitalization and amortization of policy acquisition costs. These estimated savings assume that gross written premiums produced by the former Cash Register offices remain consistent with their historical levels of production.

Reduction in Quota Share Reinsurance. In 2003, we used $51.9 million of the proceeds from our initial public offering to increase our investment in our insurance subsidiaries. In addition, we intend to use a portion of the proceeds from this offering, if any, to contribute additional capital to our insurance subsidiaries. As a result, we have been able to significantly reduce the amount of quota share reinsurance necessary for us to manage our gross and net premiums written to surplus ratios within the guidelines of the states in which we operate. During 2003, we retained 67.8% of gross premiums written as compared to 54.0% in 2002. For 2004, we expect to retain 80% to 90% of our gross premiums written. The reduction in quota share reinsurance should increase our invested assets and allow us to earn investment income on those assets. In addition, we expect to benefit from a proportionate decrease in the effective margin paid to our reinsurers.

Life Company Acquisition. On January 30, 2004, we acquired an inactive life insurance company for a total purchase price of $7.3 million, including approximately $1.3 million of goodwill. The assets of this life insurance company consist primarily of (i) licenses to conduct life and/or accident and health insurance business in 43 states and the District of Columbia and (ii) cash and debt securities with an aggregate market value of approximately $6 million. This acquisition provided us with a license to sell our life insurance product in North Carolina and includes licenses in Texas where we are currently expanding and Missouri and Virginia where we intend to expand in the future. We plan to start offering our term life insurance policies in North Carolina through this newly-acquired life insurance company during 2004.

Forward-Looking Statements. Statements made in this section, including those concerning our anticipated growth in gross revenues, our estimated gross premiums to be written in Texas in 2004 and 2005, our estimated revenue to be generated by the offices acquired in 2003 and the estimated operating expense savings with respect to those offices are forward-looking statements. These forward-looking statements involve certain known and unknown risks, uncertainties and other important factors that could cause our actual results to differ materially from our expectations. In addition to the uncertainties described in the Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations sections of this prospectus, some important factors that must occur in order for us to achieve these results include:

- increase in the renewal of insurance policies and sales of new policies;
- increase in sales of ancillary products;
- increase in sales of term life insurance policies;
- the exercise of the option to acquire the Texas independent agency network and the successful integration of its operations into ours;
- the timely and successful development and opening of up to 20 neighborhood sales offices in Texas;
- increase in sales of insurance policies in Texas through the independent agency network and our future neighborhood sales offices;
- favorable trends in inflation and other matters that could affect operating expenses;

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- our ability to effectively compete against other insurance companies and independent agencies selling similar products in our markets;
- our ability to obtain timely approval of requested rate changes; and
- the absence of unfavorable judicial and regulatory developments relative to the automobile insurance industry.

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BUSINESS

Who We Are

We are a rapidly growing provider of non-standard personal automobile insurance, premium finance and other insurance and non-insurance products and services. Our operations are concentrated in the southeastern part of the United States. From 1999 to 2003, our total revenues grew from $139.4 million to $317.1 million and our gross revenues grew from $204.3 million to $523.8 million, representing a compounded annual growth rate of 22.8% and 26.5%, respectively. Net income over this same period increased from $7.6 million in 1999 to $43.1 million in 2003.

Our Business Model

We believe that our success is due, in large part, to the strength of our business model, which integrates the operations of our insurance, premium finance and agency subsidiaries. Our model emphasizes the distribution of our products and services through neighborhood sales offices staffed by employee-agents as opposed to commissioned agents. Relative to the independent agency distribution model relied upon by many of our insurance competitors, our business model allows us to generate significant revenue from sources other than premiums from our core product, non-standard personal automobile insurance. These additional revenues include premium finance revenues, commissions from the sale of non-core insurance products and other revenues, none of which entails insurance underwriting risk. In the independent agency distribution model, these additional revenues would typically be paid to an unaffiliated premium finance company, independent agent, or other third party. These additional revenues totaled $49.4 million in 2001, $62.9 million in 2002 and $78.5 million in 2003, which represented 31.9%, 29.5% and 24.8% of total revenues and equaled 80.3%, 95.4% and 97.0% of our total operating expenses for 2001, 2002 and 2003, respectively. We believe that our ability to produce these revenues from sources other than our core product is a substantial competitive advantage. The diagrams below summarize the differences between our business model and the independent agency distribution model.

Our Products and Services

Our core business involves issuing non-standard personal automobile insurance policies. These policies, which generally are issued for the minimum limits of coverage required by state laws, provide coverage to drivers who cannot obtain insurance from standard carriers due to a variety of factors, including the lack of

flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle.

Through our premium finance subsidiary, we finance the majority of the insurance policies that we sell. Premium finance involves making a loan to the customer backed by the unearned portion of the insurance premiums being financed, which is the portion of the loan attributable to future periods of coverage. We offer our customers a variety of flexible payment plans that allow for low down payments, which we believe is a significant factor our customers consider when purchasing insurance.

We offer a variety of other insurance products designed to appeal to purchasers of our non-standard personal automobile insurance policies, including term life insurance currently offered through one of our wholly-owned life insurance subsidiaries, as well as vehicle protection insurance, travel protection insurance and hospital indemnity insurance underwritten by unaffiliated insurers, for which we receive a commission but do not bear insurance underwriting risk. We are exploring the possibility of offering additional insurance products, such as renters , homeowners (including mobile homeowners), motorcycle, boat and personal watercraft policies. These additional insurance products may either be underwritten by unaffiliated insurers, from which we would receive a commission, or underwritten by us, with the majority of the underwriting risk expected to be ceded to unaffiliated reinsurers from which we would receive a ceding commission.

The following table summarizes the components of our gross revenues for the periods indicated.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions)				
Gross premiums:					
Gross premiums written automobile	$ 421.7	$ 327.6	$ 234.8	$ 178.3	$ 156.4
Gross premiums written life	13.5	7.6	3.9	1.1	0.1
Total gross premiums	$ 435.2	$ 335.2	$ 238.7	$ 179.4	$ 156.5
Ancillary income(1):					
Finance income	44.9	35.7	27.3	24.6	21.6
Commission and service fee income	33.6	27.2	22.1	21.9	21.1
Total ancillary income	78.5	62.9	49.4	46.5	42.7
Net investment income including realized gains (losses) on securities	10.1	5.2	7.3	5.0	5.1
Gross revenues(2)	$ 523.8	$ 403.3	$ 295.4	$ 230.9	$ 204.3

(1) Ancillary income includes income derived from revenue sources that do not entail insurance underwriting risk.

(2) Gross revenues, which we consider to be a non-GAAP financial measure, is defined as gross premiums written, including direct premiums written and assumed premiums written, finance income, commission and service fee income, net investment income and net realized gains (losses) on securities. See Management s Discussion and Analysis of Financial Condition and Results of Operations Measurement of Results .

Our Favorable Cost Structure

We emphasize the use of neighborhood sales offices staffed by employee-agents as opposed to commissioned agents, thereby replacing a variable operating cost structure with a largely fixed operating cost structure. Our sales offices staffed by company employees enable us to capture a significant source of ancillary income that does not entail insurance underwriting risk. Compared to companies operating under the traditional non-standard automobile insurance business model, where revenues from underwriting operations

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must cover the operating costs, our ancillary income provides us with a significant source of additional revenues.

We also rely on distribution relationships with independent agencies, generally as a transitional step in the acquisition of those agencies. We currently have a distribution relationship with an independent agency in Texas, which commenced in January 2003. We have an option to acquire that Texas agency in December 2004. In pursuing our strategy of expansion in selected states, since 1991 we have acquired and integrated 11 independent insurance agencies with over 170 sales offices in five states.

We seek to attract customers by developing strong brand name recognition in our markets through our low-cost television advertising campaigns that emphasize our low down payments, flexible payment plans, convenient neighborhood locations and customer service. Our television advertising campaign is designed to generate telephone inquiries to our neighborhood sales offices or our centralized call center where indications of estimated premiums are given to prospective customers, who are then directed to the nearest neighborhood sales office.

Our neighborhood offices serve as a channel for both product delivery and payment collection. Our widespread and convenient local presence appeals to our customers, most of whom would prefer to conduct business face to face rather than by telephone or the Internet. All policy applications are completed in the neighborhood sales offices, and most of our customers revisit these offices at least monthly to make their periodic payments.

The following table summarizes our operating costs and the percentage of such costs covered by ancillary income for the periods indicated.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions)				
Ancillary income	$ 78.5	$ 62.9	$ 49.4	$ 46.5	$ 42.7
Operating expenses:					
Selling, general and administrative costs	$ 74.5	$ 59.7	$ 53.9	$ 47.5	$ 53.2
Interest expense	6.4	6.2	7.6	8.8	6.7
Total operating expenses	$ 80.9	$ 65.9	$ 61.5	$ 56.3	$ 59.9
Ratio of ancillary income to total operating expenses	97.0%	95.4%	80.3%	82.6%	71.3%

Our Strengths

We believe that our strengths provide a foundation for profitable growth.

Our integrated business model enables us to better manage our business and capture a significant amount of premium finance revenues, term life insurance premiums, commissions from the sale of non-core insurance products and other revenues that would typically be paid, in an independent agency distribution model, to an unaffiliated premium finance company, independent agent or other third party.

Our broad sales office network, which emphasizes the use of employee-agents, is the cornerstone of our relationship with our customers, who typically would prefer to conduct business face to face than by telephone or on the Internet.

Our premium finance operations, which support almost all of the policies that we sell, provide attractive payment plans for our policyholders and allow us to adjust payment plan structures to meet changes in market demands more quickly than most of our competitors.

Our favorable cost structure enables us to leverage our largely fixed cost neighborhood sales offices staffed by company employees and reduce our marginal operating cost as we increase revenues.

Our ancillary revenues, including premium finance revenues, commissions from the sale of non-core insurance products and other revenues, none of which currently entails insurance underwriting risk, defray a significant amount of our operating expenses.

Our claims settlement philosophy and procedures have been designed with a clear emphasis on controlling costs through the use of our employee-staffed claims operations.

Our controlled policy underwriting and pricing are supported by an integrated point of sale agency system and back office control system.

Strong name branding in our markets results from our extensive use of television advertising and the presence of our neighborhood sales offices throughout the states in which we operate.

Our Future Growth

We intend to continue our growth primarily through:

Increasing Revenues in Existing Markets. We are focused on increasing revenues in our existing markets by:

generating new customers through our advertising campaigns; and

increasing the sales of our non-core insurance and non-insurance products and services.

Expanding Our Product and Service Offerings. We intend to expand the range of non-core insurance and non-insurance products and services we offer.

Expanding Our Distribution Network. We intend to expand into new states through acquisitions of local agencies and the opening of new sales offices. In January 2003, we began our expansion into Texas through an independent agency relationship that includes an option to acquire the agency s business in December 2004. We also intend to begin our expansion into Missouri during 2004 and Virginia during 2005 through the opening of new sales offices.

Our Market

The personal automobile insurance market is comprised of preferred, standard and non-standard insurance segments. The coverages offered by these segments generally include liability (coverage for losses suffered by third parties), physical damage, personal injury protection (no-fault) and uninsured/ underinsured motorist coverages. The non-standard automobile insurance coverages, which are generally issued for the minimum limits of coverage required by state laws, provide coverage to drivers who cannot obtain insurance from standard carriers due to a variety of factors, including lack of flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle. In general, customers in the non-standard market have higher average premiums for a comparable amount of coverage than customers who qualify for the standard market. The higher average premiums compared to the standard market generally result from an increased frequency of losses, which is partially offset by the lower severity of losses resulting from lower limits of coverage. While there is no established industry-recognized demarcation between non-standard and other personal automobile insurance markets, based upon data compiled from A.M. Best, we believe that, as of December 31, 2002, the size of the non-standard automobile market segment in the United States was approximately $30 billion representing approximately 20% of the total personal automobile insurance market.

In our experience, customers of the non-standard segment generally consider four primary factors when purchasing a personal automobile insurance policy:

down payment;

payment frequency and amount;

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total policy premium; and

customer service.

Our products, premium financing capabilities, neighborhood accessibility, policyholder service, and claims service are designed to meet the needs of our customers, in a manner that recognizes and accommodates our customers lifestyles and financial capabilities.

Our Competition

The non-standard automobile insurance business is highly competitive. Since we emphasize sales of insurance policies through neighborhood sales offices staffed by employee-agents, we primarily compete against independent agencies that market insurance on behalf of a number of insurers. We compete with these other insurers based on factors such as price, availability of flexible payment plans, customer service, and claims service. Competition is also based on the availability and quality of products, financial strength, distribution systems and technical expertise.

Based upon data compiled from A.M. Best, we believe that, as of December 31, 2002, ten insurance groups accounted for approximately 70% of the approximately $30 billion non-standard market segment. We believe that our primary insurance company competition comes not only from national companies or their subsidiaries, such as the Progressive insurance group, the Allstate insurance group, the Infinity insurance group, the State Farm insurance group, the Berkshire Hathaway insurance group (including GEICO) and the Bristol West insurance group, but also from non-standard insurers and independent agents that operate in a specific region or single state in which we operate. Based upon our direct written premiums for 2002, we believe that, as of December 31, 2002, we would be ranked 17th nationally and sixth in the nine states in which we operated among non-standard automobile insurers, using the 2002 market data compiled from A.M. Best.

Marketing and Distribution

Television advertising is our most heavily used and, we believe, our most effective advertising medium for reaching our customers. We believe that our local sales office presence, along with our extensive television advertising, allows us to generate strong brand name recognition in our markets.

Television Advertising. Our commercials are frequently aired over all of our markets on network-affiliated stations. As a result of our bulk purchase advertising, the average 30-second television commercial is relatively inexpensive. Additionally, we advertise in The Real Yellow Pages® in selected markets. We believe that we have achieved meaningful brand recognition in our markets, particularly compared to other non-standard personal automobile insurers and independent agencies.

Our advertisements present potential customers with a local phone number, as well as a toll free number for our customer service center in Baton Rouge, Louisiana, and encourage the potential customer to call us for information. Indications of estimated premiums are provided by our employee-agents in our neighborhood sales offices or our representatives located in our customer service center in Baton Rouge. Once the preliminary estimates have been provided, prospective customers are directed to the nearest neighborhood sales office where our employee-agents assist in the completion of the policy application, provide an explanation of coverages and policy options, perform an inspection of the insured vehicle and finalize the quote for the coverages selected. Employee-agents then complete the premium finance agreement and collect all amounts due under the policy or premium finance agreement.

Neighborhood Sales Offices. Our neighborhood sales office distribution system comprises offices that we have developed, offices that we have obtained through strategic acquisitions of agency operations, offices of an independent agency that we have an option to purchase and a small number of offices of other independent agents. Beginning in January 2003, we began distributing the insurance product of an unaffiliated insurer in Texas through an independent agency. We have an option to acquire this agency in December 2004. Our strategy is to place our sales offices in a strip mall on a major thoroughfare in well-populated areas of cities and

towns with a population of at least 12,000. We currently lease almost all of our offices subject to operating leases with terms ranging from one month to three years.

We have grown, and we intend to continue to grow, our business by expanding our neighborhood sales office network through the acquisition of independent insurance agencies and the opening of new neighborhood sales offices. The acquisition of independent insurance agencies generally involves the purchase of only the assets of the agency (including customer lists, rights to the agency name and the exclusive right to solicit the customer), and the assumption of certain agreed upon liabilities (generally, office space and equipment leases). We typically hire the employee-agents of the acquired agency and in many cases hire key managers, as well. The acquisition purchase price, which is based on an arm s-length negotiation, generally varies with the volume of non-standard personal automobile insurance premiums produced by the agency over the twelve months preceding the acquisition.

Since our inception, we have acquired the assets of 11 independent insurance agencies using this model that included over 170 neighborhood offices in five states. In March 1998, we were presented with an opportunity to acquire the assets of a Florida agency and its 64 neighborhood sales offices in Florida for an aggregate purchase price of $7.5 million which was our initial entry into the Florida market. The primary purpose of our other acquisitions was to increase our sales office network in both new and existing states. In our initial expansion into Tennessee, we completed five acquisitions in 1992 and one acquisition in 1993 of relatively small agencies that contributed a total of 16 offices for a total cost of approximately $2.2 million. Our initial entrance into Louisiana in 1994 and 1995 was aided by two acquisitions of Louisiana agencies that included a total of 30 offices for an aggregate purchase price of approximately $1.5 million. In January 1999, we paid $1.9 million for the assets of an independent agency that included 23 offices in Tennessee, Kentucky and Georgia. Additionally, in November 2003, we paid $13.8 million for the assets of an independent agency that included 42 offices in Florida. Because only a minimal amount of tangible assets was acquired in these transactions, the majority of the purchase price in all of these acquisitions was attributable to goodwill. The portion of goodwill associated with these acquisitions was $20.1 million at December 31, 2003.

We currently have an agreement with an independent insurance agency network to produce business for us in Texas. The agency network includes sales office locations operated by employee-agents and under franchise agreements. We have an option to acquire the assets of the Texas agency in December 2004, including the option to acquire the rights as franchisor in accordance with the franchise agreement.

We believe that our convenient neighborhood sales office concept is an essential component of our business model. Our licensed employee-agents have frequent direct contact with our customers. This direct contact gives us an opportunity to establish a personal relationship with the customer, who in our experience generally prefers face-to-face interaction, and helps us provide quality and efficient service. Our customers use neighborhood sales offices not only to purchase automobile insurance, but also as a convenient location to make their periodic payments and purchase other insurance and non-insurance products and services.

Employee-Agents. We believe that our emphasis on the use of employee-agents has made a significant contribution to the overall success of our business model. At our neighborhood sales offices, our employee-agents provide quotes on insurance premiums and payment plan options, sell non-standard personal automobile insurance policies and other insurance and ancillary products, process the relevant forms, inspect the customer s vehicle and collect and process payments. Additionally, our agents provide other customer support functions, such as contacting customers when they are late on their payments or advising customers when their policies are up for renewal. This level of personal interaction with our customers helps us identify opportunities to provide additional products and services.

Internet Sales. Through an independent agency, we have recently entered into an arrangement that permits our personal automobile insurance polices to be sold and premiums financed over the Internet. This pilot program is limited to one state and will allow us to analyze whether this method of distribution appeals to our customer base.

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Our Products and Services

Non-Standard Personal Automobile Insurance

Non-standard personal automobile insurance policies constitute our core product. These policies, which generally are issued for the minimum limits of coverage required by state laws, provide coverage to drivers who cannot obtain insurance from standard carriers due to a variety of factors, including the lack of flexible payment plans, the failure to maintain continuous coverage, age, prior accidents, driving violations, occupation and type of vehicle. In general, customers in the non-standard market have higher average premiums for a comparable amount of coverage than customers who qualify for the standard market. The higher average premiums compared to the standard market generally result from an increased frequency of losses, which is partially offset by the lower severity of losses resulting from lower limits of coverage.

We believe that the majority of our customers do not qualify for insurance from standard carriers because of financial reasons, including the failure to maintain continuous coverage. In 2003, over 75% of the drivers included under our insurance policies had no points associated with moving violations on their driving record at the time they purchased their policy.

The following table provides a summary of gross personal automobile insurance premiums written for the periods indicated.

		Year Ended December 31,				
		2003	2002	2001	2000	1999
		($ in millions)				
Gross premiums written	Automobile	$ 421.7	$ 327.6	$ 234.8	$ 178.3	$ 156.4

Individual Term Life Insurance

In 1999, we began offering our customers individual term life insurance policies with $10,000 of coverage through our life insurance subsidiary. These are basic, one-year term policies that are guaranteed to be renewable for two additional one-year periods. Underwriting for this product generally consists of applicants answering certain health related questions. This product is sold in our neighborhood sales offices by our licensed employee-agents in each of the states in which we operate with the exception of North Carolina, where our life insurance company is not currently licensed, and Texas. Our employee-agents presently receive a small commission on the sale of this term life product.

On January 30, 2004, we acquired an inactive life insurance company for a purchase price of $7.3 million. The assets of this life insurance company consist primarily of (i) licenses to conduct life and accident and health insurance business in 43 states and the District of Columbia and (ii) cash and debt securities with an aggregate market value of approximately $6 million. We acquired licenses to sell our life insurance product in North Carolina, and in Texas, where we are currently expanding, and in Missouri and Virginia where we intend to expand in the future. We plan to start offering our term life insurance policies in North Carolina through this newly-acquired life insurance company during 2004 and will begin transferring our current life insurance business in other states from our existing life insurance company to the newly-acquired company. We may also use this newly-acquired company to offer life insurance products in other states where we may expand in the future.

The following table provides a summary of gross term life insurance premiums written for the periods indicated.

		Year Ended December 31,				
		2003	2002	2001	2000	1999
		($ in millions)				
Gross premiums written	Life	$ 13.5	$ 7.6	$ 3.9	$ 1.1	$ 0.1

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Premium Finance

In 2003, our premium finance subsidiary financed the premiums on 94% of the insurance policies that we sold and approximately 96% excluding the policies produced through the Texas agency network which are one month term polices and are not financed. Premium finance involves making a loan to the customer that is backed by the unearned portion of the insurance premiums being financed. We offer our customers a variety of payment plans that allow for low down payments.

We believe that the amount of down payment and the availability of flexible payment plans are two of the primary factors that our customers consider when purchasing non-standard personal automobile insurance. Down payment and payment plans typically are offered by insurers and agents in the form of either installment billing or premium financing arrangements. Insurers typically use installment billing arrangements to bill for the premium of a single policy. Independent agents, who may offer policies from multiple insurers, use premium financing to finance multiple policies through one premium finance agreement. We have chosen to use premium financing versus installment billing because we believe it offers several advantages, including:

- the ability to finance multiple policies through a single premium finance agreement,
- returns comparable to or exceeding those of installment billing,
- a greater flexibility of payment plan structure and down payment,
- the ability to generate revenues in our non-insurance subsidiaries, and
- a more defined regulatory framework for financing premiums.

In a typical premium finance arrangement, the premium finance company lends the amount of the premium (minus the insured s down payment) to the insured and pays it to the insurance company on behalf of the insured. The insured makes periodic payments to the premium finance company over the term of the finance agreement. Our payment plans and down payments are developed giving consideration to expected default rates and their timing and the amount of the unearned portion of the insurance premiums being financed, which backs the loan.

If the policy is cancelled before its term expires, the policyholder has a right to receive a return of the unearned premium. Under a premium finance agreement, the policyholder assigns this right to the premium finance company to secure his or her obligations under the loan. If the policyholder fails to make a payment, the premium finance company has the right to request the insurance company to cancel the policy and pay to the premium finance company the amount of any unearned premium on the policy. If the amount of unearned premium exceeds the balance due on the loan plus any interest and applicable fees owed by the policyholder to the premium finance company, then the premium finance company returns the excess amount to the policyholder in accordance with applicable law.

The regulatory framework under which our premium finance procedures are established is generally set forth in the premium finance statutes of the states in which we operate. Among other restrictions, the interest rate we may charge our customers for financing their premiums is limited by these state statutes. In Arkansas, which has not enacted legislation or established premium finance regulations, we are generally subject to the usury laws of that state that are applicable to consumer loans. See Regulatory Environment Premium Finance Regulation for additional information about state usury and other regulatory restrictions applicable to our premium finance operations.

We strive to mitigate the risk of the insured s default under the premium finance agreement by designing payment plans that give consideration to the principal amount of the loan that is outstanding and the unearned premium backing the loan (as noted above) and by acting on a timely basis to request cancellation of the policy if the policyholder defaults on his or her obligation to repay the premium finance loan. Our premium finance operations are integrated with our sales office and insurance policy administration systems. Because of the efficiencies derived from the integration of these systems and the attractiveness of our payment plans, our overall profitability is enhanced by our premium finance operations.

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The following table provides a summary of our finance income for the periods indicated.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions)				
Finance income	$ 44.9	$ 35.7	$ 27.3	$ 24.6	$ 21.6

Ancillary Insurance Products and Administrative Services

We also offer ancillary insurance products and services designed to meet the needs of our customers. In doing so, we take advantage of our largely fixed cost neighborhood sales offices staffed by company employees to generate commission income for us with minimal incremental cost. The unaffiliated insurance companies that underwrite these products bear the insurance risk associated with these policies. The commission income generated from sales of these policies is a revenue source that is not typically available to non-standard personal automobile insurance companies that utilize the independent agency business model.

The ancillary insurance products we currently offer include vehicle protection, travel protection, and hospital indemnity. These insurance policies generally provide coverage and options that include reimbursement for medical expenses and hospital room coverage as a result of injuries sustained in automobile accidents, reimbursement for premiums for bail bonds, ambulance assistance in the event of automobile accidents, automobile rental reimbursement if the insured vehicle is involved in an accident or is stolen and reimbursement for personal effects losses caused by damage to rented automobiles.

Our agency and administrative subsidiaries produce and service non-standard personal automobile insurance and ancillary insurance products for other insurers. We receive administrative service fees for the agency, underwriting, policy administration and claims adjusting services performed on behalf of these unaffiliated insurers. Additionally, our insurance subsidiaries generally assume a portion of the non-standard personal automobile business, and in some cases assume the entire premium and related insurance risk, through reinsurance treaties.

The following table provides a summary of our commission and service fee income generated from sales of ancillary insurance products and the administration of products on behalf of unaffiliated insurers for the periods indicated.

	Year Ended December 31,				
	2003	2002	2001	2000	1999
	($ in millions)				
Commission and service fee income	$ 33.6	$ 27.2	$ 22.1	$ 21.9	$ 21.1

We are exploring the possibility of offering additional insurance products, such as renters , homeowners (including mobile homeowners), motorcycle, boat and personal watercraft policies. These additional insurance products may either be underwritten by unaffiliated insurers, from which we would receive a commission, or underwritten by us, with the majority of the underwriting risk expected to be ceded to unaffiliated reinsurers from which we would receive a ceding commission.

We have also been studying the feasibility of providing other administrative services to third party insurers. Such administrative services could include managing general agency, underwriting and accounting services, reinsurance consulting and other management services provided for a fee to a risk retention group that would provide excess liability stop loss insurance for contractual liabilities of members of the group. These contractual liabilities are expected to initially relate to medical benefits. The fees or commissions we might generate from these services would not involve the assumption by us of any insurance underwriting risk. We are considering providing these other administrative services through our existing subsidiaries or a new subsidiary. Any new subsidiary may either be wholly owned by us or majority owned by us, in which case third party investors would own the remaining equity interests in the new subsidiary.

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Other Products and Services

We offer other non-insurance products and services designed to appeal to our customers. Our intention is to continue to expand the number of insurance and non-insurance products and services offered to our existing customers and to attract new customers to our neighborhood sales offices. We anticipate that the additional flow of potential customers will provide us with the increased opportunity to sell our core product and generate additional revenue streams that further leverage our largely fixed cost distribution system. Revenues from sales of our other non-insurance products and services have not been meaningful to date.

The non-insurance consumer products and services we currently offer include prepaid cellular telephones, prepaid local telephone and long distance phone services. We typically receive commissions and fees from unaffiliated third party vendors for the sale of these products and services. In July 2003, we hired a senior officer for our consumer products subsidiary who has extensive experience in retail sales and marketing. We have begun to study the feasibility of offering a variety of consumer retail products and consumer financial services, including pre-paid debit cards and short-term consumer loans, which we believe will appeal to our customers. We currently plan to introduce a pre-paid debit card at selected offices in the second quarter of 2004 and anticipate that additional products and services may be test marketed in selected sales offices as early as the third quarter of 2004.

Underwriting and Pricing

Non-Standard Personal Automobile Insurance. We strive to diligently price and closely control the underwriting standards for our non-standard personal automobile insurance policies that we sell. We generally do not sell personal automobile insurance policies to persons whom we deem to have an excessive number of points on their driving record. Our underwriting and rating systems are fully automated, including on-line driving records and on-line credit scoring in some of the states in which we operate. We believe that our automated underwriting and pricing controls provide a significant competitive advantage to us, because these controls give us the ability to capture relevant pricing information, improve efficiencies, increase the accuracy and consistency of underwriting decisions and reduce training costs. Our controls can be changed easily on a state-by-state basis to reflect new rates and underwriting guidelines necessary to compete effectively in our markets.

We set premium rates based on specific type of vehicle, garage location and the driver s age, gender, marital status, driving experience and location. Currently, we use credit scoring as an additional rating factor in Kentucky and South Carolina. We seek to maintain competitive, but adequate, rates to attract responsible drivers in our non-standard market. We review loss trends in every state on a quarterly basis to identify changes in frequency and severity, and to assess the adequacy of our rates and underwriting standards. We are committed to maintaining discipline in our pricing by adjusting rates, as necessary, to maintain or improve profit margins in each market.

Individual Term Life Insurance. Our underwriting of individual term life insurance polices is limited, due to the face amount of the policies being $10,000. Applicants are required to provide proof of age and answer six questions that are designed to determine the possible existence of serious health conditions. Our guidelines prohibit issuance of a term life insurance policy to any applicant that currently has any of the conditions mentioned in the underwriting questions.

Claims Handling

We believe that one of the most significant keys to our success is our disciplined focus on controlling the claims process and claims costs. Since non-standard personal automobile insurance customers generally have a higher frequency of claims than preferred and standard insurance customers, it is important that we successfully manage the claims process and claims costs to limit our losses. The entire claims process is managed by our in-house claims operation. By controlling this process, rather than having all or parts of it outsourced to third parties, we can quickly assess claims, identify loss trends early and manage against fraud. We can also readily capture information that is useful in establishing loss reserves and determining premium

rates. We believe that our claims process is designed to promote expedient, fair and consistent claims handling, while controlling loss adjustment expenses.

As of January 31, 2004, our claims operation had a staff of approximately 500 employees, including adjusters, appraisers, re-inspectors, special investigators and claims administrative personnel. We conduct our claims operations out of two major regional claims centers and three smaller regional centers. Our employees handle all claims from the initial report of the claim until the final settlement. The regional claims offices are assigned geographic service areas with enough flexibility for any office to handle claims from other areas, as claims volume, workloads and available staff require. We believe that our in-house employment of salaried claims personnel, including appraisers and adjusters, and our control of the entire claims process result in a reduction of our ultimate loss payments, lower loss adjustment expenses and improved customer service.

All of our claims personnel are hired and trained in our in-house training program regardless of previous experience. In addition to initial training, we support continuing education of seasoned claims staff to ensure that they are up to date in all of the newest claims processes, fraud detection and legislative and litigation issues. In addition to other qualifications, our field and re-inspection appraisers typically have obtained hands-on experience with automobile body and mechanical repair before we employ them.

While we are strongly committed to promptly and fairly settling the meritorious claims of our customers and claimants, we are equally committed to defending against non-meritorious claims. Litigated claims and lawsuits are primarily managed by one of our specially trained litigation adjusters. Suspicious claims are referred to our special investigation unit, which we refer to as our SIU. Our SIU routinely investigates claims reflecting repetitive fact patterns or other unusual circumstances. Our SIU has been involved with investigations, assisting local authorities in combating fraud, organized crime and fraud rings in the states in which we conduct business.

We seek to minimize our claims litigation defense costs by attempting to negotiate flat-fee representation with outside counsel specializing in automobile insurance claim defense. Generally, the fee covers all activity from opening a litigation file through final disposition of the case. We believe that our efforts to obtain high quality claims defense litigation services at a fixed or carefully controlled cost have helped us control claims losses and expenses.

Loss and Loss Adjustment Expense Reserves

Automobile accidents generally result in insurance companies paying amounts to individuals or companies resulting from physical damage to an automobile or other property and an injury to a person. Months and sometimes years may elapse between the occurrence of an accident, reporting of the accident to the insurer and payment of the claim. Insurers record a liability for estimates of losses that will be paid for accidents reported to it, which we refer to as case reserves. In addition, since accidents are not always reported promptly upon the occurrence, insurers estimate liabilities for accidents that have occurred but have not been reported to the insurer, which we refer to as incurred but not reported or IBNR reserves.

We are directly liable for loss and loss adjustment expenses under the terms of the insurance policies underwritten by our insurance subsidiaries. Each of our insurance subsidiaries establishes a reserve for all unpaid losses and loss adjustment expenses, which we occasionally refer to as LAE, including case and IBNR reserves and estimates for the cost to settle the claims. We rely primarily on historical loss experience in determining reserve levels, on the assumption that historical loss experience provides a good indication of future loss experience. We also give consideration to various factors, such as inflation, historical claims, settlement patterns, legislative activity and litigation trends. We continually monitor these estimates and, if necessary, increase or decrease the level of our reserves as experience develops or new information becomes known.

We believe that the liabilities that we have recorded for unpaid losses and loss adjustment expenses are adequate to cover the ultimate net cost of losses and loss adjustment expenses incurred to date. We periodically review our methods of establishing case and IBNR reserves and update our estimates. Our actuarial staff performs quarterly comprehensive reviews of reserves and loss trends. In addition, Ernst & Young LLP, our independent consulting actuary, provides certification of our reserves at each year end.

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The following table presents development information on changes in reserves for losses and loss adjustment expenses of our insurance subsidiaries for the periods indicated.

	Year Ended December 31,		
	2003	2002	2001
	($ in millions)		
Balance at beginning of period	$ 86.9	$ 77.5	$ 74.0
Less reinsurance recoverables on unpaid losses	29.0	40.5	39.5
Net balance at beginning of period	57.9	37.0	34.5
Losses and LAE incurred, net of reinsurance related to:			
Current period	168.1	106.1	86.1
Prior period	.1	(5.5)	7.8
Net losses and LAE incurred during the current year	168.2	100.6	93.9
Deduct losses and LAE paid, net of reinsurance, related to:			
Current period	107.6	66.6	60.2
Prior period	43.8	13.1	31.2
Net claim payments made during the current period	151.4	79.7	91.4
Net balance at end of period	74.7	57.9	37.0
Plus reinsurance recoverables on unpaid losses	37.9	29.0	40.5
Balance at end of period	$ 112.6	$ 86.9	$ 77.5

Net loss and LAE incurred included the impact of minimal unfavorable development in 2003 of $0.1 million, favorable development in 2002 of $5.5 million that included $1.8 million related to the commutation of certain reinsurance contracts, and unfavorable development of $7.8 million in 2001 that included $6.5 million relating to the write-off of reinsurance recoverables from Reliance Insurance Company. The remaining favorable and unfavorable development is primarily a result of changes in frequency and severity trends.

The portion of net losses and LAE paid during 2002 that related to prior periods was lower than other periods because the payment of $13.1 million was net of $10.5 million of reinsurance payments received in conjunction with the commutation of a reinsurer s obligation for unpaid losses and $7.4 million of reinsurance payments received in conjunction with the commutation of our stop loss reinsurance agreement.

The table provided after the following paragraph presents the development of reserves, net of reinsurance, from 1993 through 2003. The top line of the table presents the reserves at the balance sheet date for each of the years indicated. This represents the estimated amounts of losses and loss adjustment expenses for claims arising in all years that were unpaid at the balance sheet date, including losses that had been incurred but not yet reported to us. The upper portion of the table presents the cumulative amounts paid as of the end of each successive year with respect to those claims. The lower portion of the table presents the re-estimated amount of the previously recorded reserves based on experience as of the end of each succeeding year, including cumulative payments made since the end of the respective year. The estimate changes, as more information becomes known about the payments, frequency and severity of claims for individual years. Favorable loss development, shown as a cumulative redundancy in the table, exists when the original reserve estimate is greater than the re-estimated reserves. Information with respect to the cumulative development of gross reserves (that is, without deduction for reinsurance ceded) also appears at the bottom portion of the table.

In evaluating the information in the table provided below, you should note that each amount entered incorporates the cumulative effects of all changes in amounts entered for prior periods. You should also note that the table does not present accident or policy year development data. In addition, conditions and trends that have affected the development of liability in the past may not necessarily recur in the future. The net cumulative deficiency of $5.4 million in 1999 and $9.3 million in 2000 included approximately $0.9 million

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and $6.5 million, respectively, related to the write-off of reinsurance recoverables from Reliance Insurance Company.

	As of December 31,										
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
	($ in millions)										
Reserves for losses and loss adjustment expense:											
Originally estimated	$ 5.2	$ 12.9	$ 16.8	$ 16.0	$ 18.4	$ 31.4	$ 33.9	$ 34.5	$ 37.0	$ 57.9	$ 74.7
Cumulative amounts paid as of:											
One year later	3.6	8.6	10.1	9.7	9.7	18.4	25.0	31.2	13.1	43.8	
Two years later	4.6	10.9	13.3	12.4	12.2	24.8	33.7	35.3	26.9		
Three years later	5.3	12.0	14.3	13.2	13.7	27.6	36.1	41.3			
Four years later	5.5	12.2	14.6	13.7	14.4	28.7	38.4				
Five years later	5.6	12.3	14.9	13.9	14.7	29.3					
Six years later	5.6	12.4	15.0	14.0	14.8						
Seven years later	5.6	12.5	15.0	14.1							
Eight years later	5.6	12.5	15.1								
Nine years later	5.6	12.5									
Ten years later	5.6										
Reserves re-estimated as of:											
One year later	6.1	13.4	15.9	15.7	16.6	29.1	36.2	43.1	31.5	58.0	
Two years later	5.8	13.3	16.2	15.6	15.6	28.8	38.3	42.7	33.6		
Three years later	5.9	13.2	16.0	14.9	15.3	29.4	38.7	43.8			
Four years later	5.8	12.9	15.5	14.6	15.1	29.5	39.3				
Five years later	5.8	12.8	15.3	14.3	14.8	29.7					
Six years later	5.7	12.6	15.2	14.1	14.9						
Seven years later	5.7	12.5	15.0	14.1							
Eight years later	5.6	12.5	15.1								
Nine years later	5.6	12.5									
Ten years later	5.6										
Cumulative deficiency/(redundancy):	$ 0.4	$ (0.4)	$ (1.7)	$ (1.9)	$ (3.5)	$ (1.7)	$ 5.4	$ 9.3	$ (3.4)	$ 0.1	
Gross liability originally estimated	$ 12.5	$ 21.0	$ 23.1	$ 21.0	$ 25.7	$ 39.9	$ 53.2	$ 74.0	$ 77.5	$ 86.9	$ 112.6
Reinsurance recoverables	7.3	8.1	6.3	5.0	7.3	8.5	19.3	39.5	40.5	29.0	37.9
Net liability originally estimated	$ 5.2	$ 12.9	$ 16.8	$ 16.0	$ 18.4	$ 31.4	$ 33.9	$ 34.5	$ 37.0	$ 57.9	$ 74.7
Gross estimated liability latest	$ 15.3	$ 19.8	$ 20.6	$ 18.3	$ 21.9	$ 38.1	$ 62.2	$ 82.0	$ 79.0	$ 87.6	$ 112.6
Reinsurance recoverables latest	9.7	7.3	5.5	4.2	7.0	8.4	22.9	38.2	45.4	29.6	37.9
Net estimated liability as of 2003.	$ 5.6	$ 12.5	$ 15.1	$ 14.1	$ 14.9	$ 29.7	$ 39.3	$ 43.8	$ 33.6	$ 58.0	$ 74.7
Gross cumulative deficiency/(redundancy)	$ 2.8	$ (1.2)	$ (2.5)	$ (2.7)	$ (3.8)	$ (1.8)	$ 9.0	$ 8.0	$ 1.5	$ 0.7	
Net cumulative deficiency/(redundancy):	$ 0.4	$ (0.4)	$ (1.7)	$ (1.9)	$ (3.5)	$ (1.7)	$ 5.4	$ 9.3	$ (3.4)	$ 0.1	

Reinsurance

Summary

Reinsurance refers to an arrangement in which a company called a reinsurer agrees in a contract (often referred to as a treaty) to assume specified risks written by an insurance company (known as a ceding company) by paying the insurance company all or a portion of the insurance company s losses arising under specified classes of insurance policies. Insurance companies like us use reinsurance to reduce their exposures,

to increase their underwriting capacity and to manage their capital more efficiently, among other reasons. We have historically relied on various quota share and excess of loss reinsurance treaties to maintain our exposure to loss at or below a level that is within the capacity of our capital resources to handle. In quota share reinsurance, the reinsurer agrees to assume a specified percentage of the ceding company s losses arising out of a defined class of business (for example, 50% of all losses arising from non-standard automobile insurance written in a particular state in a particular year), in exchange for a corresponding percentage of premium. In excess of loss reinsurance, the reinsurer agrees to assume all or a portion of the ceding company s losses, in excess of a specified amount (called the attachment point or the ceding company s retention), arising out of a defined class of business (for example, 80% of all losses in excess of $50 million, or all losses in excess of $50,000 per policy, arising from non-standard auto insurance written in a particular state in a particular year). In excess of loss reinsurance, the premium payable to the reinsurer is negotiated by the parties based on their assessment of the amount of risk being ceded to the reinsurer because the reinsurer does not share proportionately in the ceding company s loss.

Historically, we have ceded a portion of our non-standard automobile insurance premiums and losses to unaffiliated reinsurers in accordance with these contracts. However, we have not ceded any portion of our life insurance premiums and losses to reinsurers since the life premium volume is relatively low. Ceded premiums written were equal to 32.2%, 46.0% and 52.7% of our gross premiums written for the years ended December 31, 2003, 2002 and 2001, respectively. Increases to our statutory surplus in 2002 and 2003 enabled us to retain more of the business we underwrote and reduced our use of quota share reinsurance. In addition to quota share, we cede all of the premiums and losses associated with policies written for coverage limits in excess of the state required minimum coverages. Only a minimal amount of our non-standard automobile policies are written at these higher limits. We also maintain catastrophe excess of loss reinsurance that provides coverage for losses up to $15 million, less our retention of 100% of the first $2 million of losses and 2.5% of the losses covered under this reinsurance arrangement in order to limit our exposure to losses from a single catastrophic event such as a hurricane, earthquake, or hailstorm.

The following amounts are reflected in our financial statements as a result of reinsurance arrangements:

	Year Ended December 31,									
	2003		2002		2001		2000		1999	
	Written	Earned	Written	Earned	Written	Earned	Written	Earned	Written	Earned
	($ in millions)									
Direct premiums	$ 410.0	$ 370.9	$ 326.6	$ 276.1	$ 229.8	$ 200.8	$ 177.8	$ 164.8	$ 149.7	$ 123.0
Assumed premiums	25.2	24.0	8.6	8.2	8.9	6.4	1.6	4.6	6.8	20.5
Gross premiums	435.2	394.9	335.2	284.3	238.7	207.2	179.4	169.4	156.5	143.5
Ceded premiums	(140.1)	(166.4)	(154.2)	(139.3)	(125.8)	(109.2)	(106.9)	(95.5)	(79.2)	(51.9)
Net premiums	$ 295.1	$ 228.5	$ 181.0	$ 145.0	$ 112.9	$ 98.0	$ 72.5	$ 73.9	$ 77.3	$ 91.6

Reinsurance Risks

Reinsurance is subject to certain risks, particularly credit risk, which relates to our ability to collect the payments for reinsured losses due from our reinsurers, and market risk, which affects the cost and availability of reinsurance.

Credit Risk. We attempt to select financially strong reinsurers with an A.M. Best rating of A- or better and continue to evaluate their financial condition and monitor various credit risks to minimize our exposure to losses from reinsurer insolvencies. However, we remain obligated for amounts ceded in the event that the reinsurers do not meet their obligations. Following the insolvency of one of our reinsurers, Reliance Insurance Company, which resulted in our write-off of our entire $11.1 million receivable (as described in Management s Discussion and Analysis of Financial Condition and Results of Operations Overview of Operating Results Reinsurance Recoverable Write-off), we have implemented several changes to our reinsurance program over the past several years designed to reduce our exposures to the credit risk from uncollectible reinsurance recoverables. These changes include shifting the settlement of reinsurance premiums

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to an earned basis versus a written basis, requiring reinsurers to fund a trust account or provide a letter of credit in the event of a downgrade by A.M. Best below a specified level and limiting the maximum participation by any one reinsurer.

In September 2003, the A.M. Best Company downgraded the financial strength rating of one of our reinsurers, SCOR Reinsurance Company (SCOR) to B++ (Very Good) from A- (Excellent) . SCOR, a participant in our reinsurance treaties since July 2001, has established a trust account for our benefit totalling $7.9 million at December 31, 2003. In addition, for settlements occurring subsequent to the downgrade, we are retaining an amount equal to the unsecured portion of their obligations to us for losses and unearned premiums.

Our reinsurers have established letters of credit and trust accounts covering $17.5 million of their obligations to us at December 31, 2003, which resulted in unsecured reinsurance recoverables of $32.7 million as of December 31, 2003, compared to $31.4 million as of December 31, 2002. The largest unsecured recoverable from a single reinsurer was $9.2 million as of December 31, 2003, compared to $12.2 million as of December 31, 2002.

The following table provides a summary of our reinsurance recoverables by reinsurer as of December 31, 2003.

Reinsurer	A.M. Best Rating	Net Recoverable on Paid Losses	Net Receivable on Reserves	Funds Held and Ceded Premiums Payable	Net Exposure to Reinsurer	Amount Secured by Letters of Credit or Trust Accounts
				($ in millions)		
AXA Corporate Solutions	A- (Excellent)	$ 0.6	$ 1.5	$	$ 2.1	$ 2.1
Dorinco Reinsurance	A- (Excellent)	3.4	21.5	14.8	10.1	1.3
Folksamerica Reinsurance Co.	A (Excellent)	0.4	1.1		1.5	
National Union Fire Insurance	A++ (Superior)	3.3	22.4	16.5	9.2	
Overseas Partners	NR-5 (Not Rated)	1.8	4.8		6.6	6.2
SCOR Reinsurance Co.	B++ (Very Good)	2.6	20.0	11.9	10.7	7.9
Swiss Re America	A+ (Superior)	3.3	22.4	16.5	9.2	
Other Reinsurers		0.3	0.6	0.1	0.8	
Total		$ 15.7	$ 94.3	$ 59.8	$ 50.2	$ 17.5

Market Risk. The reinsurance market has changed dramatically over the past few years as a result of inadequate pricing, poor underwriting and the significant losses incurred in conjunction with the terrorist attacks on September 11, 2001. As a result, generally reinsurers have exited lines of business, reduced available capacity, and implemented provisions in their contracts designed to reduce or limit their exposure to loss.

Beginning in 2001, in an effort to manage the cost of quota share reinsurance in the time of rising cost and limited availability, we added provisions for loss ratio corridors and loss ratio caps to our quota share reinsurance agreements that reduce the cost of reinsurance to us. These provisions have been structured to provide the reinsurers with some limit on the amount of potential loss being assumed, while maintaining the transfer of significant insurance risk with the possibility of a significant loss to the reinsurer. Loss ratio corridors provide for layers of losses in which the reinsurer does not participate in the losses while loss ratio caps cut off the reinsurer s liability for losses above a specified loss ratio. We believe our reinsurance arrangements qualify for reinsurance accounting in accordance with SFAS 113 Accounting for Reinsurance Contracts . There was no effect from the loss ratio cap provisions in our 2003, 2002 and 2001 agreements. However, the net incurred losses were increased due to the impact of loss corridor provisions by approximately $0.8 million attributed to our 2003 agreements, $0.5 million attributable to our 2002 agreements and $1.7 million attributable to our 2001 agreements.

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2004 Reinsurance Program

Quota Share. For policies written in 2004, we maintain a quota share agreement covering personal automobile insurance policies up to the respective state s minimum statutory limits of coverage. In addition, coverages for rental, towing, and accidental death are excluded from these agreements. The agreement covers business written in our existing states (including Texas) and would cover business written in our targeted expansion states of Missouri and Virginia. The agreement provides us with the ability to cede varying amounts of business, which we refer to as cession percentages, from each of our property and casualty insurance subsidiaries.

Dorinco Reinsurance Company (30%), National Union Fire Insurance Company of Pittsburgh (30%), a member of American International Group, Swiss Reinsurance America Corporation (30%), and AXA Re(Paris) (10%) participate in the agreement. This agreement includes a sliding scale commission, loss ratio corridor and a loss ratio cap.

Excess Cessions. Consistent with prior years, we entered into an excess cessions reinsurance agreement whereby the reinsurers are liable for 100% of the ultimate net losses in excess of the respective state s compulsory and/or financial responsibility automobile liability limits. This business is ceded to SCOR Reinsurance Company (50%) and QBE Reinsurance Corporation (50%), rated A (Excellent) by A.M. Best.

Catastrophe Reinsurance. We purchased property catastrophe excess of loss reinsurance that provides coverage for losses up to $15 million, less our retention of both 100% of the first $2 million of losses and 2.5% of losses covered under this reinsurance arrangement. The contract covers in force, new, renewed, and assumed personal automobile physical damage business with the maximum value per vehicle covered of $75,000. If we incur losses from a catastrophic event that results in recoveries under this contract, we have the option to purchase one reinstatement of coverage with a $26 million aggregate limitation for all losses occurring during the term of the agreement. Based on computer modeling, we believe this level of coverage is more than sufficient to cover our probable maximum loss from a once in a thousand year catastrophic event. Losses from terrorist events including nuclear, chemical and biochemical acts are excluded from coverage. Our catastrophe reinsurers for 2004 include IPCRe Limited, rated A+ (Superior) by A.M. Best, Endurance Specialty Insurance Limited, rated A (Excellent) by A.M. Best, QBE Reinsurance Corporation, XL Re Limited, rated A+ (Superior) by A.M. Best, and certain syndicates from Lloyd s of London.

Assumed Reinsurance. Effective January 1, 2003, we agreed to assume a 100% quota share percentage of certain personal automobile liability and physical damage business in Texas underwritten by Old American County Mutual Fire Insurance Company, an unaffiliated insurance company, for which we are responsible for sales, service and claims administration related to such business. We also assume a significant portion of the personal automobile physical damage business in North Carolina underwritten by State National Insurance Company, an unaffiliated insurance company for which we sell, service, finance and administer claims related to such business.

Technology

The effectiveness of our business model depends in large part on the technology systems we have developed specifically to implement our business model. Our technology systems enable timely and efficient communication and data sharing among the various segments of our integrated operations. The coordination of the operations of our neighborhood sales offices, insurance companies, premium finance company and claims company provides us with the opportunity to use technology more effectively than many of our competitors who must communicate with unaffiliated premium finance companies and with a large number of independent agents, many of which use different computer systems that may not be fully compatible with the insurance company s systems. Our central processing computer is an IBM iSeries located in Nashville, Tennessee, which was upgraded in October 2002. As part of our business continuity plan, we also maintain a backup IBM AS/400 in Baton Rouge, Louisiana. These systems maintain our official transaction records and are updated each night. The capacity of the iSeries computer permits historical detail to be maintained and available for use in rate analysis, projections and modeling.

Sales Office Automation. We strive to standardize and integrate the technology systems between and among our subsidiaries that facilitate the automated capture of information at the earliest point in the sales cycle. All of our neighborhood sales office computers transmit information directly to our central processing computer located in Nashville where policy information and premium finance agreement data are added to our systems with nominal additional manual handling. Our sales offices also have immediate on-line access to current information on policies and premium finance agreements by a common computer interface or through a distributed database downloaded from our iSeries central processing computer.

We strive to enhance the current sales office system and improve our back office integration. These systems include features for issuing policies and premium finance agreements, processing new business and renewals, generating all necessary documents at the neighborhood sales offices, and, in the future, for processing all endorsements. Ultimately, we expect to eliminate the mailing of declaration pages, ID cards, payment coupon books and other documents from the main office. Connection to the iSeries is through an Internet virtual private network.

Integration of Insurance and Premium Finance Systems. The integration of the policy processing and premium finance computer systems reduces much of the time consuming paper-based transactions that typically arise in this process. Technology is used to process policy cancellations, reinstatements and return premiums between our insurance subsidiaries and our premium finance company, resulting in reduced overhead, more timely information and improved customer service. Throughout this process, our systems generate the appropriate statutory notices which are mailed automatically to the insured.

Payment Processing. Most of our customers revisit our sales offices at least monthly to make a periodic payment on their premium finance agreement. System generated receipts are required for all payments collected in our sales offices. Our sales offices generate balancing reports at the end of each day, prepare bank deposit documents and transmit all payment records to our Nashville office. Depository accounts are swept daily, which results in prompt availability of funds. Typically, premium finance agreement payments are automatically applied to the applicable premium finance agreement during the night following their collection in our sales offices. This results in fewer notices of intent to cancel being generated from the premium finance company and fewer policies being canceled by the insurance company, which must be reinstated if a customer s late payment is processed after cancellation. Thus, not only are mailing costs reduced, but we believe that unnecessary policy cancellations also are kept to a minimum, which in turn leads to better customer relations.

Ratings

A.M. Best rates insurance companies based on factors of concern to policyholders. Three of our property and casualty insurance subsidiaries have been assigned a B (Fair) rating and our other property and casualty insurance subsidiary has been assigned a B- (Fair) rating. A.M. Best assigns 15 ratings to insurance companies, which currently range from A++ (Superior) to F (In Liquidation) .

B (Fair) and B- (Fair) are the seventh and eighth highest ratings, respectively. Publications of A.M. Best indicate that the B (Fair) and B-(Fair) rating is assigned to those companies that in A.M. Best s opinion have a fair ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions. In evaluating a company s financial and operating performance, A.M. Best reviews the company s profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its loss reserves, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. A.M. Best s ratings reflect its opinion of an insurance company s financial strength, operating performance and ability to meet its obligations to policyholders, and are not evaluations directed to potential or current investors in our common stock and are not recommendations to buy, sell or hold our common stock.

Financial institutions and reinsurance companies use the A.M. Best ratings to help assess the financial strength and quality of insurance companies. The current ratings of our property and casualty insurance subsidiaries or their failure to maintain such ratings may dissuade a financial institution or reinsurance

company from conducting business with us or increase our interest or reinsurance costs. We do not believe that most customers are motivated to purchase our products and services based on our A.M. Best rating.

Insurance Subsidiaries

We currently have six insurance subsidiaries. Four are property and casualty insurance companies and two are life insurance companies. The following table lists our insurance subsidiaries and their states of domicile.

Subsidiary	State of Domicile
Direct General Insurance Company	South Carolina(1)
Direct Insurance Company	Tennessee
Direct General Insurance Company of Louisiana	Louisiana
Direct General Insurance Company of Mississippi	Mississippi
Direct Life Insurance Company	Georgia
New York Life and Health Insurance Company	Delaware(2)

(1) Direct General Insurance Company is also commercially domiciled in Florida.

(2) We have filed an application to have New York Life and Health Insurance Company redomesticated to South Carolina and its name changed to Direct General Life Insurance Company.

Regulatory Environment

Insurance Regulation Generally. We and our insurance subsidiaries are regulated by governmental agencies in the states in which we conduct business and also are subject to various federal statutes and regulations. State insurance regulations generally are designed to protect the interests of policyholders, state insurance consumers or claimants rather than shareholders or other investors. These state regulations vary by jurisdiction but, among other matters, usually involve:

- regulating premium rates and forms;
- setting minimum solvency standards;
- setting capital and surplus requirements;
- licensing companies, agents and, in some states, adjusters;
- setting requirements for and limiting the types and amounts of investments;
- establishing requirements for the filing of annual statements and other financial reports;
- conducting periodic statutory examinations of the affairs of insurance companies;
- requiring prior approval of changes in control and of certain transactions with affiliates;
- limiting the amount of dividends that may be paid without prior regulatory approval; and
- setting standards for advertising and other market conduct activities.

Required Licensing. We operate under licenses issued by various state insurance, consumer credit and banking authorities. Such licenses may be of perpetual duration or renewable periodically, provided we continue to meet applicable regulatory requirements. The licenses govern, among other things, the types of insurance coverages, agency and claims services, and premium finance products that may be offered in the licensing state. Such licenses are typically issued only after the filing of an appropriate application and the satisfaction of prescribed criteria. All

licenses that are material to our business are in good standing. Currently, we hold property and liability insurance licenses in the states of Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, South Carolina and Tennessee. Also, we hold managing general agency licenses in Florida and Texas and life insurance licenses in 44 states and the District of Columbia. We hold the

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required premium finance licenses in all states in which we currently operate. We must apply for and obtain the appropriate new licenses before we can implement any plan to expand into a new state or offer a new line of insurance or other new product that requires separate licensing.

Insurance Holding Company Regulation. We operate as an insurance holding company system and are subject to regulation in the jurisdictions in which our insurance subsidiaries conduct business. These regulations require that each insurance company in the system register with the insurance department of its state of domicile and furnish information concerning the operations of companies within the holding company system which may materially affect the operations, management or financial condition of the insurers within the system domiciled in that state. We have insurance subsidiaries that are organized and domiciled or commercially domiciled under the insurance statutes of each of Delaware, Florida, Georgia, Louisiana, Mississippi, South Carolina and Tennessee. The insurance laws in each of these states similarly provide that all transactions among members of a holding company system must be fair and reasonable. Transactions between insurance subsidiaries and their parents and affiliates generally must be disclosed to the state regulators, and prior approval of the applicable state insurance regulator generally is required for any material or extraordinary transaction. In addition, a change of control of a domestic insurer or of any controlling person requires the prior approval of the state insurance regulator. Generally, any person who acquires 10% or more of the outstanding voting securities of the insurer or its parent company (5% or more in Florida) is presumed to have acquired control of the domestic insurer.

Restrictions on Paying Dividends. We rely, in part, on receiving dividends from our insurance subsidiaries to meet our cash requirements. State insurance regulatory authorities require insurance companies to maintain specified levels of statutory capital and surplus. The amount of an insurer s surplus following payment of any dividends must be reasonable in relation to the insurer s outstanding liabilities and adequate to meet its financial needs. Prior approval from state insurance regulatory authorities is generally required in order for our insurance subsidiaries to declare and pay extraordinary dividends to us. The maximum amount of dividends our insurance subsidiaries can pay us during 2004 without regulatory approval is $10.5 million. The payment of dividends is limited by the amount of surplus available to the insurer, as determined in accordance with state statutory accounting practices and other applicable limitations. State insurance regulatory authorities that have jurisdiction over the payment of dividends by our insurance subsidiaries may in the future adopt statutory provisions more restrictive than those currently in effect.

Regulation of Rates and Policy Forms. Most states in which our insurance subsidiaries operate have insurance laws requiring insurance companies to file premium rate schedules and policy or coverage forms for review and approval. In many cases, such rates and policy forms must be approved prior to use. State insurance regulators have broad discretion in judging whether an insurer s rates are adequate, not excessive and not unfairly discriminatory. Property and casualty insurers are generally unable to implement rate increases until they show that the costs associated with providing such coverage have increased. The speed at which an insurer can change rates in response to competition or to increasing costs depends, in part, on the method by which the applicable state s rating laws are administered. There are three basic rate administration systems: (i) the insurer must file and obtain regulatory approval of the new rate before using it; (ii) the insurer may begin using the new rate and immediately file it for regulatory review; or (iii) the insurer may begin using the new rate and file it within a specified period of time for regulatory review. Under all three rating systems, the state insurance regulators have the authority to disapprove the rate subsequent to its filing. Thus, insurers who begin using new rates before the rates are approved may be required to issue premium refunds or credits to policyholders if the new rates are ultimately deemed excessive and disapproved by the applicable state insurance authorities. In addition, in some states, there has been some pressure in the past years to reduce premium rates for automobile and other personal insurance or to limit how often an insurer may request increases for such rates.

Shared or Residual Markets. As a condition of maintaining our automobile insurance licenses to do business in various states, like other insurers, we are required to participate in mandatory shared market mechanisms or state pooling arrangements. The purpose of these state-mandated arrangements is to provide insurance coverages to individuals who, because of poor driving records or other underwriting reasons, are unable to purchase such coverage voluntarily provided by private insurers. These risks are assigned to all

insurers licensed in the state and the maximum volume of such risks that any one insurer may be assigned typically is based on that insurer s annual premium volume in that state. While this mandated business typically is not profitable for us, our underwriting results related to these states organizations have not been material to our overall results of operations and financial condition.

Guaranty Funds. Under state insurance guaranty fund laws, insurers doing business in a state can be assessed for certain obligations of insolvent insurance companies to policyholders and claimants. Maximum contributions required by law in any one year vary between 1% and 2% of annual premiums written in that state. In most states guaranty fund assessments are recoverable either through future policy surcharges or offsets to state premium tax liability.

Investment Regulation. Our insurance subsidiaries are subject to state laws and regulations that require diversification of their investment portfolios and that limit the amount of investments in certain categories. Failure to comply with these laws and regulations would cause non-conforming investments to be treated as non-admitted assets for purposes of measuring statutory surplus and, in some instances, would require divestiture.

Other Insurance Regulatory Initiatives and Proposed Legislation. Regulation of insurance companies constantly changes as governmental agencies and legislatures react to real or perceived issues. In recent years, the state insurance regulatory framework has come under increased federal scrutiny, and some state legislatures have considered or enacted laws that alter and, in many cases, increase state authority to regulate insurance companies and insurance holding company systems. Further, the NAIC and state insurance regulators are re-examining existing laws and regulations specifically focusing on issues relating to the solvency of insurance companies, interpretations of existing laws and the development of new laws. Examples of these regulatory initiatives and proposals that may affect our business or operations include:

- the approval by the U.S. House of Representatives in June 2003 and consideration by the U.S. Senate of class action tort reform legislation that would allow defendants to move large national class actions from state courts to federal courts. The legislation also purports to provide protections to consumer class members;

- restrictions on the use of credit scoring by insurance companies when deciding whether to cover, or how much premium to charge, potential customers, which have been in recent years, and continue to be, a frequent subject of state legislation. On the federal level, a U.S. House of Representatives subcommittee has held hearings to determine whether credit scoring is a fair and cost effective tool for assessing risk;

- the examination by committee hearings of the U.S. House of Representatives of whether federal legislation is needed to establish uniform standards for state insurance regulation. The National Association of Independent Insurers (now known as The Property Casualty Insurers of America) has stated that it expects legislation to be introduced in the House that would address areas of concern such as product availability, speed to market of new products, and insurance agent licensing;

- the implementation of the Fair and Accurate Credit Transactions Act and the duties and responsibilities that will be imposed on insurers concerning affiliate sharing of information and adverse action notices;

- the proposal by NAIC to use a best practices process to develop a market conduct model that would apply consistent standards among multiple state insurance departments;

- reevaluation by the NAIC of current RBC formulas which could lead to a recommendation to change the company action level in the RBC Model Act (see Regulatory Environment Risk Based Capital);

- various state legislative initiatives that purport to benefit or provide protection to automobile insurance consumers, such as the recent enactment in Florida of limits on the amount of deductibles that insurers may offer their customers;

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- individual state statutes and developing regulations concerning consumer privacy, including the mandate for creating specific written programs to safeguard customers privacy; and

- legislation in Texas that requires, among other things, the Department of Insurance to (i) approve premium rates and policy forms filed by county mutual insurance companies and (ii) conduct periodic examinations of the books and records of such insurance companies. This legislation will make county mutual insurance companies more closely resemble other property and casualty insurers conducting business in Texas.

Restrictions on Cancellation, Non-Renewal or Withdrawal. Many states have laws and regulations that limit an insurer s ability to exit a market. For example, certain states limit an automobile insurer s ability to cancel or not renew policies. Some states prohibit an insurer from withdrawing one or more lines of business from the state, except pursuant to a plan approved by the state insurance department. The state insurance department may disapprove a plan that may lead to market disruption. Laws and regulations that limit cancellations and non-renewals and that subject business withdrawals to prior approval requirements may restrict an insurer s ability to exit unprofitable markets.

Premium Finance Regulation. Our premium finance subsidiary is regulated by governmental agencies in states in which it conducts business. The agency responsible for such regulation varies by state, but generally is the banking department or the insurance department of the applicable state. These regulations, which generally are designed to protect the interests of our policyholders who elect to finance their insurance premiums, vary by jurisdiction, but usually, among other matters, involve:

- regulating the interest rates, fees and service charges we may charge our customers;

- imposing minimum capital requirements for our premium finance subsidiary or requiring surety bonds in addition to or as an alternative to such capital requirements;

- governing the form and content of our financing agreements;

- prescribing minimum notice and cure periods before we may cancel a customer s policy for non-payment under the terms of the financing agreement;

- prescribing timing and notice procedures for collecting unearned premium from the insurance company, applying the unearned premium to our customer s premium finance account, and, if applicable, returning any refund due to our customer;

- establishing standards for filing annual financial reports of our premium finance company;

- requiring our premium finance company to qualify for and obtain a license and to renew the license each year;

- conducting periodic financial and market conduct examinations and investigations of our premium finance company and its operations; and

- requiring prior notice to the regulating agency of any change of control of our premium finance company.

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The following table sets forth the maximum permissible interest rate in the nine states in which we currently finance insurance premiums:

State	Permissible Interest Rate
Arkansas	Variable(1)(2)
Florida	12.0%(3)
Georgia	12.0%(3)
Kentucky	12.0%(3)
Louisiana	36.0%(2)
Mississippi	24.0%(2)
North Carolina	12.0%(3)
South Carolina	12.0%(3)
Tennessee	24.0%(2)

(1) The maximum allowable interest rate in Arkansas is equal to 500 basis points above the Federal Reserve discount rate on 90-day commercial paper.

(2) In these states the maximum permissible interest rate is calculated on an actuarial basis, meaning that the interest is calculated to apply to the average of balances outstanding throughout the period of indebtedness.

(3) In these states the maximum permissible interest rate is calculated on an add-on basis, meaning that the annual interest rate is applied to the initial amount financed.

Four of these nine states require our premium finance subsidiary to maintain a specified minimum net worth, post a surety bond or deposit securities with the state regulator.

In addition, our premium finance business is subject to the federal Truth-in-Lending Act and similar state statutes, and in Arkansas, which has not enacted a premium finance statute, we generally are subject to state usury laws that are applicable to consumer loans.

Privacy Regulations. In 1999, the United States Congress enacted the Gramm-Leach-Bliley Act, which protects consumers from the unauthorized dissemination of certain personal information. Subsequently, the majority of states have implemented additional regulations to address privacy issues. These laws and regulations apply to all financial institutions, including insurance and finance companies, and require us to maintain appropriate procedures for managing and protecting certain personal information of our customers and to fully disclose our privacy practices to our customers. We may also be exposed to future privacy laws and regulations, which could impose additional costs and impact our results of operations or financial condition.

Regulation of Our Ancillary Product Vendors. The vendors of the ancillary products and services we offer to our customers are also subject to various federal and state laws and regulations. The failure of any vendor to comply with such laws and regulations could affect our ability to sell the ancillary products or services of that particular vendor. However, we believe that there are adequate alternative vendors of all the material ancillary products and services sold by us.

Licensing of Our Employee Agents and Adjustors. Generally, all of our employees who sell, solicit or negotiate insurance are required to be licensed by the state in which they work for the applicable line or lines of insurance they offer. Our employee-agents generally must renew their licenses annually and complete a certain number of hours of continuing education. In certain states in which we operate, insurance claims adjusters are also required to be licensed and some must fulfill annual continuing education requirements.

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Trade Practices. The manner in which insurance companies and insurance agents conduct the business of insurance is regulated by state statutes in an effort to prohibit practices that constitute unfair methods of competition or unfair or deceptive acts or practices. Prohibited practices include, but are not limited to:

- disseminating false information or advertising;
- defamation;
- boycotting, coercion and intimidation;
- false statements or entries;
- unfair discrimination;
- rebating;
- lessening competition by a stock transaction;
- improper replacement of life insurance;
- improper use of proprietary information;
- illegal dealings in premiums;
- excess or reduced charges for insurance; and
- sliding, packaging and other deceptive sales conduct.

We set business conduct policies and provide regular training to make our employee-agents and other sales personnel aware of these prohibitions, and we require them to conduct their activities in compliance with these statutes.

Claims Practices. Generally, insurance companies, adjusting companies and individual claims adjusters are prohibited by state statutes from engaging in unfair claims practices on a flagrant basis or with such frequency to indicate a general business practice. Unfair claims practices include, but are not limited to:

- misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
- failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
- failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;
- attempting to settle a claim for less than the amount to which a reasonable person would have believed such person was entitled;
- attempting to settle claims on the basis of an application which was altered without notice to or knowledge or consent of the insured;
- making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration;
- delaying the investigation or payment of claims by requiring an insured, claimant, or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information;

failing to promptly settle claims, where liability has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage; and

not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.

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We set business conduct policies and conduct regular training to make our employee-adjusters and other claims personnel aware of these prohibitions, and we require them to conduct their activities in compliance with these statutes.

Quarterly and Annual Financial Reporting. We are required to file quarterly and annual financial reports with states utilizing statutory accounting practices that are different from GAAP, which reflect our insurance subsidiaries on a going concern basis. The statutory accounting practices used by state regulators, in keeping with the intent to assure policyholder protection, are generally based on a liquidation concept. For a summary of the significant differences for our insurance subsidiaries between statutory accounting practices and GAAP, see Note 11 to our audited consolidated financial statements included in this prospectus.

Periodic Financial and Market Conduct Examinations. The state insurance departments that have jurisdiction over our insurance subsidiaries conduct on-site visits and examinations of the insurers affairs, especially as to their financial condition, ability to fulfill their obligations to policyholders, market conduct, claims practices and compliance with other laws and applicable regulations. Typically, these examinations are conducted every three to five years. In addition, if circumstances dictate, regulators are authorized to conduct special or target examinations of insurers, insurance agencies and insurance adjusting companies to address particular concerns or issues. The results of these examinations can give rise to regulatory orders requiring remedial, injunctive or other corrective action on the part of the company that is the subject of the examination.

Risk Based Capital. In order to enhance the regulation of insurer solvency, the NAIC has adopted a formula and model law to implement RBC requirements designed to assess the minimum amount of capital that an insurance company needs to support its overall business operations and to ensure that it has an acceptably low expectation of becoming financially impaired. RBC is used to set capital requirements considering the size and degree of risk taken by the insurer and taking into account various risk factors such as asset risk, credit risk, underwriting risk, interest rate risk and other relevant business risks. The NAIC model law for RBC applies to both life and property and casualty companies. The model law provides for increasing levels of regulatory intervention as the ratio of an insurer s total adjusted capital and surplus decreases relative to its risk based capital, culminating with mandatory control of the operations of the insurer by the domiciliary insurance department at the so-called mandatory control level. At December 31, 2003, each of our insurance subsidiaries maintained an RBC level that is in excess of an amount that would require any corrective actions on our part.

IRIS Ratios. The NAIC Insurance Regulatory Information System or IRIS is part of a collection of analytical tools designed to provide state insurance regulators with an integrated approach to screening and analyzing the financial condition of insurance companies operating in their respective states. IRIS is intended to assist state insurance regulators in targeting resources to those insurers in greatest need of regulatory attention. IRIS consists of two phases: statistical and analytical. In the statistical phase, the NAIC database generates key financial ratio results based on financial information obtained from insurers annual statutory statements. The analytical phase is a review of the annual statements, financial ratios and other automated solvency tools. The primary goal of the analytical phase is to identify companies that appear to require immediate regulatory attention. A ratio result falling outside the usual range of IRIS ratios is not considered a failing result; rather, unusual values are viewed as part of the regulatory early monitoring system. Furthermore, in some years, it may not be unusual for financially sound companies to have several ratios with results outside the usual ranges. An insurance company may fall out of the usual range for one or more ratios because of specific transactions that are in themselves immaterial.

As of December 31, 2003, Direct General Insurance Company, Direct General Insurance Company of Louisiana and Direct Life Insurance Company each had three IRIS ratios outside the usual range; Direct Insurance Company had two IRIS ratios outside the usual range and Direct General Insurance Company of Mississippi had four IRIS ratios outside the usual range. The majority of the unusual results were attributable to the significant growth in premiums and surplus, low investment yields due to the current interest rate environment and the fact that the majority of our capital contributions occurred late in the year. We do not expect any material regulatory action as a result of these unusual results.

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Legal Proceedings

We and our subsidiaries are named from time to time as defendants in various legal actions that are incidental to our business and arise out of or are related to claims made in connection with our insurance policies, claims handling, premium finance agreements and other contracts, and employment related disputes. The plaintiffs in some of these lawsuits have alleged bad faith or extracontractual damages and some have claimed punitive damages. We believe that the resolution of these legal actions will not have a material adverse effect on our financial position or results of operations.

In addition to legal actions that are incidental to our business, one or more of our subsidiaries has been named as a defendant in a number of currently pending putative class action lawsuits. These legal actions are described below.

During 2003, we entered into a voluntary settlement agreement regarding all aspects of two proposed class actions filed in Tennessee state courts alleging, among other things, that certain business practices relating to our premium finance and insurance operations were unlawful. The settlement became final on June 9, 2003. Out of over 1.1 million settlement class members to whom notices of the settlement were sent, approximately 130 persons gave notice that they elected not to participate in the settlement (opt-out). None of the class members objected to the settlement. The court has determined that the majority of the purported opt-out notices were timely and properly submitted. The majority of the opt-out class members are represented by a single law firm; this increases the risk that new lawsuits, including an additional class action lawsuit, may be filed.

We are the subject of a purported class action in Georgia which alleges that we have wrongfully calculated unearned interest rebates owed to customers who have prepaid their premium finance account balance. In addition, the complaint contains allegations of fraud, deceptive trade practices and usury violations. This matter is in the discovery stage, and the ultimate outcome of this case is uncertain.

We are the subject of six purported class action lawsuits in Florida brought by plaintiffs alleging that we have violated Florida law in making payments to medical magnetic resonance imaging providers in Florida. The ultimate outcome of these cases is uncertain.

We are also subject to two purported class actions in Florida, each of which was filed in April 2003. One of these actions alleges that we improperly cancelled insurance policies, and the second action alleges that we charged and collected unlawful service and finance charges with respect to the financing of purported automobile club memberships. These cases are in the discovery stage, and the ultimate outcome of these cases is uncertain.

We believe that a substantial portion of the damages claimed in these purported class action lawsuits are covered by insurance, although under these policies, we will be required to pay the first $1 million of defense costs or judgments in each of these actions. It is possible that our insurance carriers could deny coverage, which, if successful, could result in our being liable for the full amount of defense costs, settlements or judgments.

We and our subsidiaries intend to vigorously defend each of the above referenced lawsuits, including any new lawsuits filed by the opt-out class members described in connection with the settled Tennessee class action. Although we are optimistic regarding our successful defense of the above cases, because of the inherent uncertainties related to this type of litigation, we are unable to predict the ultimate outcome of these cases, or the likelihood or amount of our potential liability, if any, of these cases if they are not successfully defended or settled, or the effect that these pending cases may have on our business, operations, profitability, or financial condition, if they are not successfully defended.

William C. Adair, Jr., our Chairman, Chief Executive Officer and President, has been named as a defendant in a lawsuit filed in Tennessee state court in November 2003. The complaint alleges that Mr. Adair induced the plaintiff to market a Health Plan, that Mr. Adair made certain misrepresentations to the plaintiff and that Mr. Adair breached a contract that resulted in a loss of commissions to the plaintiff. Based on these allegations, plaintiff is seeking compensatory damages and an unspecified amount of punitive

damages. We are not named as a defendant in this lawsuit; however, the plaintiff s counsel has recently stated an intention to add us as a defendant. This lawsuit against Mr. Adair is still in the early procedural stages, and the ultimate outcome of this case is uncertain. If we are named as a defendant in this lawsuit, we will vigorously defend against any claims.

Properties

We lease approximately 37,500 square feet of office space in Nashville, Tennessee for our corporate headquarters and approximately 30,000 square feet of office space in Memphis, Tennessee for our executive offices and a claims center. We also lease an aggregate of over 135,000 square feet of office space for additional claims centers in Columbia, South Carolina, Knoxville, Tennessee and Tampa, Florida and for our administrative and customer service center located in Baton Rouge, Louisiana. In addition, we lease office space for our numerous neighborhood sales offices, none of which is material to our business.

Employees

As of January 31, 2004, we employed approximately 2,000 employees. Our employees are not covered by any collective bargaining agreements.

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MANAGEMENT

Directors and Executive Officers

The following table sets forth certain information concerning our directors and executive officers as of March 22, 2004:

Name	Age	Title
William C. Adair, Jr.	62	Chairman of the Board, Chief Executive Officer and President
Jacqueline C. Adair	45	Executive Vice President, Chief Operating Officer and Director
Tammy R. Adair	40	Executive Vice President
Barry D. Elkins	43	Senior Vice President and Chief Financial Officer
William J. Harter	47	Senior Vice President Corporate Development, Banking and Finance
Brian G. Moore	51	President of Direct General Financial Services, Inc.
Ronald F. Wilson	58	General Counsel and Secretary
Fred H. Medling	79	Director
Raymond L. Osterhout	72	Director
Stephen L. Rohde	52	Director

William C. Adair, Jr. founded Direct Insurance Company, our predecessor company, in 1991 and has served as Chairman of the Board since our inception. Mr. Adair became our Chief Executive Officer in April 1998, after having served in that position with us previously, and became President in March 2001. He has over 25 years experience in insurance and related industries, including automobile insurance and reinsurance, insurance agency operations and premium financing services, claims handling, auto salvage, auto body repair and appraisals. Mr. Adair is the husband of Jacqueline C. Adair and the father of Tammy R. Adair.

Jacqueline C. Adair has been our Executive Vice President and Chief Operating Officer since September 2002. She also served as our President from September 1993 to April 1996 and Secretary from April 1996 to September 2002. Ms. Jacqueline Adair has also served as one of our directors since April 1991. She has over 20 years experience in the automobile insurance and related industries with particular experience in claims handling, auto salvage recoveries, marketing, underwriting, agency operations and other related operational aspects of an insurance and premium finance organization. Ms. Jacqueline Adair is the wife of William C. Adair, Jr. and the step-mother of Tammy R. Adair.

Tammy R. Adair has been our Executive Vice President since September 2002. Prior to joining us, she spent eleven years as a founding partner in the law firm of Adair & Schuerman, P.C. and later formed Adair, Schuerman & White, an association of defense attorneys, which provided various legal services to us. She dedicated her practice to the insurance and premium finance industries, including bad faith litigation, claims handling, form filings, policy and procedure development, employment matters, acquisitions, regulatory compliance, corporate governance, and other legal and operational aspects of an insurance and premium finance organization. Ms. Tammy Adair is the daughter of William C. Adair, Jr. and the step-daughter of Jacqueline C. Adair.

Barry D. Elkins has been our Chief Financial Officer since September 1993 and a Senior Vice President since February 2001. Mr. Elkins was a director from September 1993 to April 1996 and from February 2001 to February 2003. He also has served as our Secretary/ Treasurer from September 1993 to April 1996, and Vice President from October 1996 to February 2001. He has over ten years of public accounting experience, including with Ernst & Young, LLP from December 1983 to September 1988. He has over 19 years of experience focused primarily in the insurance industry, which includes auditing and financial reporting, reinsurance, treasury management and finance, acquisitions and insurance premium finance regulation.

William J. Harter has been our Senior Vice President Corporate Development, Banking and Finance since February 2003 and served as our Senior Vice-President Products and Development from November 1999 to February 2003. Mr. Harter has over 15 years of experience in the financial services industry. From June 1988 to November 1999, he was employed by First Tennessee Bank National Association, where he served as Senior Vice President, Metropolitan Banking. In this position, he performed corporate banking services for middle and large market companies in the mid-south region. Prior to that, Mr. Harter spent three years with NCNB National Bank (now known as Bank of America) where he sold and serviced banking products to Fortune 1000 and middle-market companies in the Pennsylvania and Delaware markets.

Brian G. Moore has been President of Direct General Financial Services, Inc., one of our subsidiaries, since March 2001. Prior to serving in this position, he served as our Treasurer from October 1996 to February 2001, as well as manager of our premium finance operations from November 1997 to March 2001. Mr. Moore has over 27 years of experience in the financial services industry including serving as director of insurance accounting for American General Financial Services, as well as associate treasurer and assistant secretary of American General Life & Accident Insurance Company.

Ronald F. Wilson has been our General Counsel since March 1998 and Secretary since September 2002. From October 1996 to March 1998, he served as our Assistant General Counsel, and from March 1998 to September 2002 he served as our Assistant Secretary. He has over 19 years of primarily in-house counsel experience as a corporate attorney working principally in the areas of securities law and regulatory compliance, finance, treasury functions, investments and general corporate law and insurance regulatory matters.

Fred H. Medling became a director on May 20, 2003. Mr. Medling retired in 1995 after serving as Vice President of Management of The People s Bank in Collierville, Tennessee for 18 years. In this position, he was responsible for the management, operational and certain regulatory aspects of this banking and finance institution.

Raymond L. Osterhout became a director on May 20, 2003. Mr. Osterhout is currently retired after serving, from 1988 to 2002, as Group Vice President of Underwriting/ Marketing and consultant for Swiss Reinsurance Corporation. He was responsible for underwriting and marketing activities throughout the United States. Mr. Osterhout has over 45 years of experience in the underwriting and reinsurance businesses.

Stephen L. Rohde has served as one of our directors since November 1996. Mr. Rohde has operated a financial consulting firm which provides services to small and mid-sized companies in the insurance industry since January 2004. From 1983 until December 2003, Mr. Rohde was employed by the Mutual Service Insurance Companies, a property/casualty and life insurance group, serving as its Vice President, Chief Financial Officer & Treasurer since 1991. Mr. Rohde has over 30 years experience in the financial functions of the insurance industry, including accounting, investments, auditing and financial reporting, reinsurance and treasury management.

Board of Directors

Our board of directors consists of five members. Our directors are divided into three classes and serve for staggered three-year terms. Our Class I director, whose term will expire in 2004, is William C. Adair, Jr. Our Class II directors, whose terms expire in 2005, are Fred H. Medling and Jacqueline C. Adair. Our Class III directors, whose terms expire in 2006, are Raymond L. Osterhout and Stephen L. Rohde.

Committees of the Board of Directors

Audit Committee. Our Audit Committee is responsible for the oversight of our accounting, reporting and financial control practices. The Audit Committee reviews the qualifications of the independent auditors, selects and engages the independent auditors and informs our board of directors as to their selection and engagement, and reviews the plan, fees and results of their audit, reviews our internal controls, and considers and pre-approves any services proposed to be performed by the auditors. The Audit Committee consists of Messrs. Rohde, Medling, and Osterhout, and Mr. Rohde is the chairman of the Audit Committee. Our board of directors has determined that Mr. Rohde meets the requirements for a financial expert under the Sarbanes-

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Oxley Act of 2002 and the rules of the Securities and Exchange Commission and is independent, as defined under the Nasdaq National Market listing requirements.

Compensation Committee. Our Compensation Committee consists of Messrs. Medling and Osterhout. Mr. Osterhout is the chairman of the Compensation Committee. Until July, 2003, the Compensation Committee was comprised of William C. Adair, Jr. and two former directors, Udayan D. Ghose and R. Wilson Orr, III, with Mr. Adair serving as chairman. The Compensation Committee oversees our compensation and benefit policies and programs, including administration of our annual bonus awards and incentive plans and the evaluation of our board and management.

Nominating and Corporate Governance Committee. Our Nominating and Corporate Governance Committee consists of Messrs. Osterhout, Medling, and Rohde and oversees and assists our board of directors in developing and recommending corporate governance practices and selecting the director nominees to stand for election at annual meetings of shareholders. Mr. Osterhout is the chairman of the Nominating and Corporate Governance Committee.

Compensation Committee Interlocks and Insider Participation

Until July, 2003, William C. Adair, Jr. served as a member of the Compensation Committee of our board of directors. Also, during 2003, Mr. Adair was, and currently is, our Chief Executive Officer and President. Mr. Adair and certain members of his immediate family engaged in related transactions with us and certain of our subsidiaries as further described in Certain Relationships and Related Transactions . None of our executive officers has served as a director or member of the compensation committee of any other entity whose executive officers of such entity served on our board of directors or Compensation Committee.

Director Compensation

None of our directors who are also our employees receive compensation for serving as directors. Non-employee directors receive $20,000 annually. Non-employee directors who also serve on special or standing committees receive an additional $1,500 annually for each committee on which they serve. The chairman of the Audit Committee receives $5,000 annually. We reimburse all directors for reasonable travel expenses incurred in connection with their service as directors.

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Executive Compensation

The following table sets forth information concerning the total compensation received for services rendered to us during 2002 and 2003 by our Chief Executive Officer and our four other highest paid executive officers (such persons, together with the Chief Executive Officer, are referred to in this prospectus as the Named Executive Officers).

		Annual Compensation			Long-Term Compensation: Awards		Long-Term Compensation: Payouts	
Name and Principal Position	Year	Salary ($)(1)	Bonus ($)	Other Annual Compensation ($)	Restricted Stock Awards($)	Securities Underlying Options(#)	LTIP Payouts ($)	All Other Compensation ($)(2)
William C. Adair, Jr.	2003	368,069	350,000	3,287(3)	0	300,000	0	5,578(4)
Chairman, Chief Executive Officer and President	2002	299,988	400,000	3,709(3)	0	0	0	3,544(4)
Jacqueline C. Adair	2003	200,000	150,000	4,143(3)	0	240,000	0	5,360(5)
Executive Vice President and Chief Operating Officer	2002	193,846	175,000	2,740(3)	0	0	0	3,388(5)
Tammy R. Adair	2003	200,000	60,000	6,819(3)	0	90,000	0	6,087(6)
Executive Vice President	2002	61,538	25,000	162(3)	0	0	0	80(6)
Barry D. Elkins	2003	180,000	60,000	6,687(3)	0	30,000	0	5,888(7)
Senior Vice President and Chief Financial Officer	2002	175,385	45,000	0	0	0	0	3,382(7)
William J. Harter	2003	165,000	25,000	6,000(8)	0	18,000	0	5,315(9)
Senior Vice President	2002	163,462	25,000	5,142(8)	0	0	0	4,146(9)

(1) Salary includes amounts deferred by the employees under our 401(k) plan, except for Ms. Tammy R. Adair in 2002 who had no deferred compensation.

(2) The amount of matching contributions made on behalf of each Named Executive Officer under our 401(k) plan for 2003 may be reduced in order to comply with certain nondiscrimination tests required by the Internal Revenue Code.

(3) Consists of personal use of company-owned automobiles.

(4) Consists of $5,100 and $3,154 of matching contributions under our 401(k) plan and $478 and $390 for group life insurance premiums for 2003 and 2002, respectively.

(5) Consists of $5,100 and $3,154 of matching contributions under our 401(k) plan and $260 and $234 for group life insurance premiums for 2003 and 2002, respectively.

(6) Consists of $5,827 and $0 of matching contributions under our 401(k) plan and $260 and $80 for group life insurance premiums for 2003 and 2002, respectively.

(7) Consists of $5,654 and $3,154 of matching contributions under our 401(k) plan and $234 and $228 for group life insurance premiums for 2003 and 2002, respectively.

(8) Consists of an automobile allowance.

(9) Consists of $5,100 and $3,933 of matching contributions under our 401(k) plan and $215 and $213 for group life insurance premiums for 2003 and 2002, respectively.

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Stock Option Grants in 2003

The following table sets forth information about options granted to the Named Executive Officers in 2003. The grants described below were made under our 2003 Equity Incentive Plan. During 2003, we granted 924,000 stock options to certain executive officers and employees.

Options Grants During the Year Ended December 31, 2003

Name	Number of Securities Underlying Options Granted(#)	Percent of Total Options Granted to Employees	Exercise or Base Price ($/Share)	Expiration Date	Potential Realizable Value at Assumed Rates of Stock Price Appreciation for Option Term ($) 5%(1)	10%(1)
William C. Adair, Jr.	300,000	32.47%	$ 21.00	8/11/2013	$ 3,962,036	$ 10,040,577
Jacqueline C. Adair	240,000	25.97%	$ 21.00	8/11/2013	$ 3,169,629	$ 8,032,462
Tammy R. Adair	90,000	9.74%	$ 21.00	8/11/2013	$ 1,188,611	$ 3,012,173
Barry D. Elkins	30,000	3.25%	$ 21.00	8/11/2013	$ 396,204	$ 1,004,058
William J. Harter	18,000	1.95%	$ 21.00	8/11/2013	$ 237,722	$ 602,435

(1) The amounts in these columns are the result of calculations based on the assumption that the market price of our common stock will appreciate in value from the date of grant to the ten-year option term at rates of 5% and 10% per year. The 5% and 10% annual appreciation assumptions are required by the Securities and Exchange Commission; they are not intended to forecast possible future appreciation, if any, of our stock price.

Stock Option Exercises and Values for 2003

During the year ended December 31, 2003, no Named Executive Officer exercised stock options. The following table sets forth information with respect to unexercised stock options held by the Named Executive Officers as of December 31, 2003.

Aggregated Option Exercises During the Year

Ended December 31, 2003 and 2003 Year-End Option Values

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number of Securities Underlying Unexercised Options at Year-End Exercisable/Unexercisable(#)	Value of Unexercised In-the-Money Options at Fiscal Year-End Exercisable/Unexercisable(1)
William C. Adair, Jr.	0	N/A	0/300,000	$0/$3,630,000
Jacqueline C. Adair	0	N/A	0/240,000	$0/$2,904,000
Tammy R. Adair	0	N/A	0/90,000	$0/$1,089,000
Barry D. Elkins	0	N/A	180,000/30,000	$5,707,800/$363,000
William J. Harter	0	N/A	96,000/42,000	$2,917,440/$947,160

(1) In accordance with the rules of the Securities and Exchange Commission, values are calculated by subtracting the exercise price from the fair market value of the underlying common stock. For purposes of this table, fair market value is deemed to be $33.10, the closing price of our common stock reported for the Nasdaq National Market on December 31, 2003.

Employment Agreements

We have entered into employment agreements with each of William C. Adair, Jr., Jacqueline C. Adair, Tammy R. Adair, Barry D. Elkins and William J. Harter.

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William C. Adair, Jr. Mr. Adair s employment agreement provides that we will employ him for a period of five years commencing on August 15, 2003, the closing date of our initial public offering. We will pay Mr. Adair an annual base salary of at least $500,000, plus a discretionary bonus as may be determined by the Compensation Committee, in its sole discretion, based on his performance, our business and financial condition and operating results achieved.

We may terminate Mr. Adair s employment for cause, including (a) failure or refusal to materially perform his duties under the employment agreement; (b) failure or refusal to follow material lawful directions of the board; (c) engaging in any misconduct which materially and demonstrably injures us; (d) conviction of any felony; or (e) fraudulent or dishonest conduct. In addition, either party to the employment agreement may terminate the agreement at any time without cause. Mr. Adair may terminate his agreement for good reason, including (a) the assignment of any duties inconsistent with his status as an executive officer; (b) reduction in annual base salary or failure to include him in any stock option or equity-based benefit plan; (c) relocation of his principal place of employment to a location more than 50 miles away; or (d) any material breach by us of our obligations under the employment agreement. If we terminate his agreement without cause or if he resigns for good reason, he will be entitled to continue receiving his salary and benefits for two years, and all stock options will immediately vest. In addition, in the event Mr. Adair s employment is terminated in connection with a change in control, we will pay him a severance payment equal to three times his annual base salary and three times his highest bonus paid to him within the preceding three years. Mr. Adair has agreed not to compete with us or solicit our employees for a period of two years following certain events of termination.

Jacqueline C. Adair. Ms. Jacqueline Adair s employment agreement provides that we will employ her for a period of five years commencing on August 15, 2003, the closing date of our initial public offering. We will pay Ms. Jacqueline Adair an annual base salary of at least $200,000, plus a discretionary bonus as may be determined by the Compensation Committee, in its sole discretion, based on her performance, our business and financial condition and operating results achieved.

We may terminate Ms. Jacqueline Adair s employment for cause, including (a) failure or refusal to materially perform her duties under the employment agreement; (b) failure or refusal to follow material lawful directions of the board; (c) engaging in any misconduct which materially and demonstrably injures us; (d) conviction of any felony; or (e) fraudulent or dishonest conduct. In addition, either party to the employment agreement may terminate the agreement at any time without cause. Ms. Jacqueline Adair may terminate her agreement for good reason, including (a) the assignment of any duties inconsistent with her status as an executive officer; (b) reduction in annual base salary or failure to include her in any stock option or equity-based benefit plan; (c) relocation of her principal place of employment to a location more than 50 miles away; or (d) any material breach by us of our obligations under the employment agreement. If we terminate her agreement without cause or if she resigns for good reason, she will be entitled to continue receiving her salary and benefits for two years, and all stock options will immediately vest. Ms. Jacqueline Adair has agreed not to compete with us or solicit our employees for a period of two years following certain events of termination.

Tammy R. Adair. Ms. Tammy Adair s employment agreement provides that we will employ her for a period of five years commencing on August 15, 2003, the closing date of our initial public offering. We will pay Ms. Tammy Adair an annual base salary of at least $200,000, plus a discretionary bonus as may be determined by the Compensation Committee, in its sole discretion, based on her performance, our business and financial condition and operating results achieved.

We may terminate Ms. Tammy Adair s employment for cause, including (a) failure or refusal to materially perform her duties under the employment agreement; (b) failure or refusal to follow material lawful directions of the board; (c) engaging in any misconduct which materially and demonstrably injures us; (d) conviction of any felony; or (e) fraudulent or dishonest conduct. In addition, either party to the employment agreement may terminate the agreement at any time without cause. Ms. Tammy Adair may terminate her agreement for good reason, including (a) the assignment of any duties inconsistent with her status as an executive officer; (b) reduction in annual base salary or failure to include her in any stock option or equity-based benefit plan; (c) relocation of her principal place of employment to a location more than 50 miles away; or (d) any material breach by us of our obligations under the employment agreement. However, if

we terminate her agreement other than for cause or if she resigns for good reason, she will be entitled to continue receiving her salary and benefits for two years, and all stock options will immediately vest. Ms. Tammy Adair has agreed not to compete with us or solicit our employees for a period of two years following certain events of termination.

William J. Harter. Mr. Harter s employment agreement provides that we will employ him for a period of three years commencing on August 15, 2003, the closing date of our initial public offering. We will pay Mr. Harter an annual base salary of at least $165,000, and a discretionary bonus of up to fifty percent of his base salary if so determined by the board of directors or Compensation Committee based on our operating results achieved and his contribution toward the attainment of our objectives.

We may terminate Mr. Harter s employment for cause including (a) failure or refusal to materially perform his duties under the employment agreement; (b) failure or refusal to materially comply with instructions of the Chief Executive Officer or any of our rules or policies with regard to our operations; (c) engaging in any misconduct which materially and demonstrably injures us; (d) engaging in any unlawful conduct in connection with his duties of employment or any acts of dishonesty in connection therewith; or (e) conviction of a felony or a misdemeanor involving moral turpitude. In addition, we may terminate the agreement at any time without just cause. Mr. Harter may resign at any time, and he will receive his base compensation through the effective date of his resignation. However, if we terminate his agreement without just cause, he will be entitled to continue receiving his base compensation for a period of six months or until the expiration of the original term of the agreement, whichever is earlier. Mr. Harter has agreed not to compete with us for a period of six months following certain events of termination or until the expiration of the original term of the agreement, whichever is earlier.

Barry D. Elkins. Mr. Elkins employment agreement provides that we will employ him for a period of three years commencing on August 15, 2003, the closing date of our initial public offering. We will pay Mr. Elkins an annual base salary of at least $190,000 and a discretionary bonus of up to fifty percent of his base salary if so determined by the board of directors or Compensation Committee based on our operating results achieved and his contribution toward the attainment of our objectives.

We may terminate Mr. Elkins employment for cause including (a) failure or refusal to materially perform his duties under the employment agreement; (b) failure or refusal to materially comply with instructions of the Chief Executive Officer or any rules or policies with regard to our operations; (c) engaging in any misconduct which materially and demonstrably injures us; (d) engaging in any unlawful conduct in connection with his duties of employment or any acts of dishonesty in connection therewith; or (e) conviction of a felony or of a misdemeanor involving moral turpitude. In addition, we may terminate the agreement at any time without just cause. Mr. Elkins may resign at any time, and he will receive his base compensation through the effective date of his resignation. However, if we terminate his agreement without just cause, he will be entitled to continue receiving his base compensation and health benefits for a period of six months or until the expiration of the original term of the agreement, whichever is earlier. Mr. Elkins has agreed not to compete with us for a period of six months following certain events of termination or until the expiration of the original term of the agreement, whichever is earlier.

1996 Employee Stock Incentive Plan

In 1996, our board of directors adopted and our shareholders approved our 1996 Employee Stock Incentive Plan to attract, retain, and reward selected officers, key employees, and consultants through the granting of stock-based compensation awards. As described below, no further awards will be made under this plan. However, awards previously granted under this plan will remain outstanding. The plan provides for a variety of awards, including nonqualified stock options, incentive stock options (within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended), stock appreciation rights, and restricted stock awards. As of December 31, 2003, our board had granted options to purchase 1,914,000 shares of common stock under the plan, 594,000 of which options have been forfeited and the shares reestablished as available under the plan. The maximum number of shares of common stock that could have been granted under the plan is 3,000,000. This share limitation and the per-share price is subject to adjustment to reflect

any merger, reorganization, consolidation, recapitalization, extraordinary cash dividend, stock dividend, stock split, or other change in corporate structure affecting the common stock.

The plan may be administered by our board of directors or by a committee appointed by our board of directors comprised of not less than two disinterested persons (as defined by the Securities Exchange Act of 1934). Our Compensation Committee administers the plan. The plan provides that the Compensation Committee has the authority to select plan participants, determine the type and amount of awards, determine when the awards will be granted, and fix all other terms and conditions of any awards.

Options under the plan are granted for a term not to exceed ten years, but may terminate earlier if the participant s employment terminates before the end of such term. In the case of an employee owning more than 10% of the total combined voting power of all classes of our stock and the stock of our subsidiaries, the term of any options granted to such person may not be more than five years. The exercise price for each incentive stock option granted is not less than 100% of the fair market value at the date of grant. In the case of an employee owning more than 10% of the total combined voting power of all classes of our stock and the stock of our subsidiaries, such exercise price shall not be less than 110% of the fair market value. For each nonqualified stock option granted under the plan, the exercise price is not less than 50% of fair market value at the date of grant.

The exercise price of each option granted under the plan may be paid (i) in cash, (ii) by note, (iii) or by any such instrument accepted by the Compensation Committee. In the sole discretion of the Compensation Committee, the exercise price may be paid in full or in part by shares of stock already owned by the optionee.

If a change of control or potential change of control occurs while any award granted under the plan remains outstanding, and if so determined by the Compensation Committee in its sole discretion, all stock options and stock appreciation rights outstanding at the time of the change of control or potential change of control will become exercisable in full immediately prior to such date and all restrictions with respect to restricted stock awards settled by payment in cash or shares to each holder. Any options or stock appreciation rights awarded to any person subject to Section 16(a) of the Exchange Act must be held at least six months after the date of grant.

Our board of directors may amend, alter, or discontinue the plan, including amending the terms of any option or other award previously granted. However, no amendment or termination of the plan may, without the participant s consent, impair the rights of any participant under any award previously granted.

In April 2003, our board of directors adopted and our shareholders approved the 2003 Equity Incentive Plan, as described below, and declared that no further awards would be granted under the 1996 Employee Stock Incentive Plan. All future stock-based incentive awards will be granted under the 2003 Equity Incentive Plan.

2003 Equity Incentive Plan

In April 2003, our board of directors adopted and our shareholders approved our 2003 Equity Incentive Plan. The purpose of this plan is to provide officers, directors, designated employees, and certain consultants and advisors with the opportunity to receive grants of incentive stock options, nonqualified stock options, restricted stock awards, stock appreciation rights, performance shares, dividend equivalent payments, and other stock-based awards. We believe that this plan will encourage the participants to contribute materially to our growth and profitability, thus benefiting our shareholders and aligning the economic interests of the participants with those of our shareholders. The aggregate number of shares of our common stock that may be issued under the plan is 1,680,000 shares. In the event of recapitalizations, reclassifications, stock splits, stock dividends and other specified corporate transactions, appropriate and equitable adjustments may be made to the number and kind of shares available for grant, as well as to other maximum limitations, under the plan, and the number and kind of shares or other rights and prices under outstanding awards.

The plan is administered by our Compensation Committee, which currently consists of two independent directors appointed by our board of directors. The Compensation Committee has the sole authority to (i) determine who will receive awards under the plan, (ii) determine the type, size and terms of the awards to be granted, (iii) determine the timing of awards and the duration of any applicable exercise period,

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(iv) determine the criteria for exercising awards and for accelerating awards, and (v) manage any other matters arising under the plan. As of March 22, 2004, our board and our Compensation Committee have granted options to purchase 1,010,000 shares of common stock under this plan, 24,000 of which have been forfeited and reestablished as available under the plan.

Options granted under the plan may be incentive stock options, as defined in section 422 of the Internal Revenue Code of 1986, as amended, or nonqualified stock options which are not intended to so qualify. An incentive stock option must expire within ten years from the date it is granted (five years in the case of options granted to holders of more than 10% of the total combined voting power of all classes of our stock and the stock of our subsidiaries). The exercise price of an incentive stock option must be at least equal to the fair market value on the date such incentive stock option is granted (110% of fair market value in the case of options granted to holders of more than 10% of the total combined voting power of all classes of our stock and the stock of our subsidiaries) and may be paid in cash, in shares valued at their then fair market value, or by such other means as the Compensation Committee may prescribe.

The Compensation Committee may grant a stock appreciation right in connection with all or any portion of an option grant as well as independent of any option grant. A stock appreciation right entitles the participant to receive the amount by which the fair market value of a specified number of shares on the exercise date exceeds an exercise price established by the Compensation Committee. The excess amount will be payable in common stock, in cash, or in such other form as determined by the Compensation Committee. The Compensation Committee may also grant restricted shares, performance shares, dividend equivalent payments, and other stock based awards subject to restrictions and limitations such as continued employment for a period of time, achieving targeted financial objectives, or any other criteria set forth by the Compensation Committee.

In the event of a change of control, all outstanding awards shall automatically vest and become fully exercisable, unless the Compensation Committee determines otherwise. If a merger takes place in which we are not the surviving corporation, all outstanding awards will be assumed or replaced with comparable awards of the surviving corporation. The Compensation Committee may require participants to surrender their outstanding awards in the event of a change of control in exchange for a payment in cash or common stock equal to the amount by which the fair market value of the shares subject to the award exceeds the exercise price of the award.

Our board of directors may amend, alter or discontinue the plan and the terms of any award previously granted. However, no amendment or termination of the plan may, without the participant s consent, impair the rights of any participant under any award previously granted.

Direct General 401(k) Plan and Trust

We have established a 401(k) plan for our employees that is intended to qualify under Sections 401(a) and 401(k) of the Internal Revenue Code of 1986, as amended. Generally, all employees are eligible to participate in the 401(k) plan on the first day of the month following completion of one hour of service. For employees hired before January 1, 2003, employer matching and profit-sharing contributions vest equally over a five-year period. For employees hired on or after January 1, 2003, employer matching and profit-sharing contributions are subject to a six-year graded vesting schedule.

Eligible employees electing to participate in the 401(k) plan may defer from one percent of their compensation up to the statutorily prescribed limit, on a pre-tax basis, by making a contribution to the plan. For the 2004 calendar year, the employee s contribution limit is generally $13,000 for individuals under age 50 and $16,000 for individuals age 50 and above. We currently make a quarterly discretionary matching contribution equal to 60% of each participant s contributions that do not exceed 5% of the participant s compensation. In order to receive quarterly discretionary matching contributions, a participant must be employed with us on the last day of each quarter or year, as applicable. We may also make an annual discretionary profit-sharing contribution. In order to receive an allocation of any discretionary annual profit sharing contribution, a participant must be employed with us on the last day of the year and have completed 1,000 hours of service during the year. The 401(k) Plan and Trust may be amended or terminated by us at any time in our sole discretion.

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PRINCIPAL AND SELLING SHAREHOLDERS

The tables below set forth certain information regarding ownership of our common stock beneficially owned as of March 23, 2004, by:

each shareholder known to us to be the beneficial owner of more than 5% of our outstanding shares of common stock,

each of our directors and Named Executive Officers,

all directors and executive officers as a group and

each of the selling shareholders.

Unless otherwise stated, the business address for each beneficial owner below is 2813 Business Park Drive, Airport Business Park, Bldg I, Memphis, TN 38118.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned Prior to Offering	Percentage of Shares Outstanding Prior to Offering	Shares Offered	Number of Shares Beneficially Owned After Offering	Percentage of Shares Outstanding After Offering
William C. Adair, Jr.(1)	671,240	3.10%		531,240	2.45%
Jacqueline C. Adair(2)	671,240	3.10%	140,000	531,240	2.45%
Tammy R. Adair(3)	6,890,160	31.81%	1,689,431	5,200,729	24.01%
Barry D. Elkins(4)	324,000	1.48%	144,000	180,000	*
1281 Murfreesboro Road					
Nashville, TN 37217					
William J. Harter(5)	109,000	*	12,000	97,000	*
Stephen L. Rohde	1,428	*		1,428	*
S. Rohde Associates, Inc.					
1966 Edgcumbe Road					
St. Paul, Minnesota 55116					
Fred H. Medling	1,000	*		1,000	*
152 W. White Road					
Collierville, TN 38017					
Raymond L. Osterhout(6)	254,736	1.18%	10,000	244,736	1.13%
P.O. Box X					
Hallstead, PA 18822					
Directors and executive officers as a group (ten persons)(7)	8,315,164	37.98%	1,995,431	6,319,733	28.87%
Name of Additional Selling Shareholder					
CPT, Inc.(8)	964,800	4.45%	300,000	664,800	3.07%
Aries Partners, L.P.(9)	718,572	3.32%	718,572		*
Aries Partners (International), L.P.(9)	300,012	1.39%	300,012		*

* Less than 1 percent.

(1) Includes 670,920 shares held by Jacqueline C. Adair, Mr. Adair s spouse, and 200 shares held by Lacey L. Adair, Mr. Adair s daughter, of which Mr. Adair disclaims any beneficial interest. Mr. Adair is not offering shares in this offering. The deduction under the column Number of Shares Beneficially Owned After Offering for Mr. Adair relates to the 140,000 shares offered by his spouse.

(2)

Includes 120 shares held by William C. Adair, Jr., Ms. Jacqueline Adair s spouse, and 200 shares held by Lacey L. Adair, Ms. Adair s step-daughter. Ms. Adair disclaims any beneficial interest in the shares held by her spouse and step-daughter.

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(3) Includes 6,272,580 shares held by the William C. Adair, Jr. Trust, of which Ms. Tammy Adair is the sole trustee and has sole voting and investment control. The William C. Adair, Jr. Trust is offering 1,629,431 shares and Ms. Adair is personally offering 60,000 shares in this offering.

(4) Includes 180,000 shares issuable upon the exercise of stock options and 59,760 shares in an IRA.

(5) Includes 56,000 shares issuable upon the exercise of stock options and 12,000 shares held jointly with Mr. Harter s mother.

(6) Includes 53,500 shares held by Wanda S. Osterhout, Mr. Osterhout s spouse.

(7) Includes 236,000 shares issuable upon the exercise of stock options.

(8) Glen H. Wright is the Vice President of CPT, Inc. Mr. Wright has been one of our regional state sales managers since 1992.

(9) Udayan D. Ghose is the majority member of Aries Partners, L.L.C., the general partner of Aries Partners, L.P. Mr. Ghose is the majority shareholder and President of Aries Partners, Inc., the investment advisor of Aries Partners (International), L.P. Mr. Ghose was a member of our board of directors from 1996 until May 19, 2003 and a member of the Compensation Committee of the board of directors during 2002.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

In October 2001, Direct General Insurance Agency, one of our subsidiaries, purchased certain real property in which William C. Adair, Jr. and Jacqueline C. Adair jointly owned an interest for approximately $0.1 million. Prior to the purchase, our subsidiary company leased this property and paid aggregate rentals of $29,400.

In 2002 and 2001, several of our subsidiaries paid an aggregate of approximately $1.4 million and $1.5 million, respectively, for various legal services, to an association of lawyers in which Tammy R. Adair held an ownership interest. In addition, during these years, this association of lawyers collected $4.1 million and $3.8 million for us, of which sums it retained $1.4 million and $1.3 million. Also, Direct Administration, Inc., one of our subsidiaries, leased property to this association of lawyers over the same period for an aggregate of $15,500 and $16,250 in 2002 and 2001, respectively. Ms. Tammy Adair has not been a member of this association since August 2002, and she no longer has an ownership interest in the firm. In exchange for her former ownership interest, her former law firm issued her a promissory note in the principal amount of approximately $0.4 million, at an annual interest rate of 7.25%. The note is payable in monthly installments and matures in December 2004.

In 2003 and 2002, Direct Administration, Inc. and Direct Adjusting Company, Inc., two of our subsidiaries, paid an aggregate of approximately $69,460 and $63,000, respectively, to Kerry Taylor for janitorial services. Ms. Kerry Taylor is an employee of the company and is the daughter of William C. Adair, Jr., step-daughter of Jacqueline C. Adair and sister of Tammy R. Adair.

In 2001, several of our subsidiaries sold salvaged vehicles to Frank Millington, the husband of Ms. Tammy R. Adair, for an aggregate amount of approximately $61,000.

In 2003, 2002 and 2001, two of our insurance subsidiaries paid Mid-South Collision, LLC approximately $0.9 million, $0.8 million, and $0.7 million, respectively, for auto body work. Mid-South Collision is owned by the step-daughter and stepson-in-law of Ms. Tammy Adair.

Stephen L. Rohde is one of our directors and until December 31, 2003 was the Chief Financial Officer, Vice President and Treasurer of Mutual Service Casualty Insurance Company. During 2002 and 2001, Mutual Service was a policy issuing carrier for business produced through our agency subsidiaries in Kentucky and North Carolina. We paid Mutual Service $0.6 million and $0.8 million in fees in 2002 and 2001, respectively, relating to $20.6 million and $27.7 million, respectively, in premiums written on policies issued by Mutual Service. Additionally, we had contractual reinsurance relationships with Mutual Service pursuant to which we assumed approximately $6.6 million and $8.9 million of premiums in 2002 and 2001, respectively. We ceased producing business for Mutual Service in November 2002; however, we continue to settle our obligations for reinsured losses related to this business.

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DESCRIPTION OF CAPITAL STOCK

Our charter authorizes 100,000,000 shares of common stock, and 10,000,000 shares of preferred stock, the rights and preferences of which may be established from time to time by our board of directors. As of March 23, 2004, 21,657,655 shares of common stock were outstanding.

Common Stock

Holders of our common stock are entitled to one vote for each share held on all matters submitted to a vote of shareholders and do not have cumulative voting rights. Thus, holders of a majority of the shares of common stock entitled to vote in any election of directors may elect all of the directors standing for election. Holders of common stock are entitled to receive ratably any dividends that may be declared by the board of directors out of funds legally available, subject to any preferential dividend rights of outstanding preferred stock. Upon our liquidation, dissolution or winding up, the holders of common stock are entitled to receive ratably the net assets available after the payment of all debts and other liabilities, subject to the prior rights of any outstanding preferred stock. Holders of common stock have no preemptive, subscription, redemption or conversion rights. All of the issued and outstanding shares of common stock will be fully paid and non-assessable. The rights, preferences and privileges of the holders of common stock are subject to, and may be adversely affected by, the rights of the holders of shares of any series of preferred stock that we may designate and issue in the future.

Preferred Stock

Under our charter, our board of directors is authorized, subject to limitations prescribed by law, without further shareholder approval, from time to time to issue up to an aggregate of 10,000,000 shares of preferred stock in one or more series and to fix or alter the designations, preferences and rights, and any qualifications, limitations or restrictions, of the shares of each of these series, including the number of shares constituting any of these series and the dividend rights, dividend rates, conversion rights, voting rights, terms of reduction, including sinking fund provisions, if any, redemption price or prices and liquidation preferences. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control. We have no present plans to issue any shares of preferred stock.

Registration Rights

Some of our shareholders, whose preferred shares were converted into restricted shares of our common stock on August 11, 2003, have registration rights. These rights cover approximately 1,000,000 shares of our common stock. If we propose to register for sale additional shares of our common stock under the Securities Act after this offering, these shareholders will be entitled to notice of the registration and inclusion of their shares in the registration process. The registration rights are not applicable to registration of securities in connection with employee benefit plans. In addition, these shareholders may demand that we file a registration statement for the sale of their shares. In either event, the underwriters for the proposed offering will have the right to limit the number of shares included in the registration. Also, these shareholders are entitled, subject to some limitations, to require us to register their shares on Form S-3 when we become eligible to use a short form. We have agreed to bear all of the expenses of any registration.

Tennessee Law and Our Charter and Bylaw Provisions; Anti-Takeover Effects

The directors comprising the board of directors are divided into three classes. After their initial term following our initial public offering, directors in each class will serve for a term of three years. The charter provides that directors can be removed only for cause by a majority of the voting power of the shares entitled to vote in the election of directors or by a majority of the board of directors then in office. Officers are chosen by and serve at the discretion of the board of directors. The charter also provides that special meetings of shareholders may be called only by the chairman of the board of directors, the chief executive officer or the president or by a majority of the board of directors.

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Our bylaws require shareholders to provide timely notice in writing to bring business before an annual meeting of shareholders. Notice for an annual meeting is timely in the following circumstances:

If we provided a notice of annual meeting of shareholders in the previous year, then a shareholder s notice must be delivered to or mailed and received at our principal executive offices at least 120 days before the first anniversary of the date of the prior year s notice.

If we did not hold an annual meeting the prior year, or if we have changed the date of the meeting to be more than 30 calendar days earlier or 60 calendar days after the anniversary of the prior meeting, different notice provisions apply. In these instances, we must receive notice from the shareholder at least 60 but no more than 90 days before the annual meeting or within ten days following the date on which notice of the date of the meeting is given to shareholders or made public, whichever first occurs.

A shareholder s timely notice to bring business before a special meeting must be delivered to us by the close of business ten days after notice of the meeting is given to shareholders. The bylaws also specify the form and content of a shareholder s notice. These provisions may prevent shareholders from bringing matters before an annual meeting of shareholders or from making nominations for directors at an annual meeting of shareholders.

Our charter requires the affirmative vote of at least 75% of the total voting power of the outstanding shares entitled to vote at an election of directors to amend or repeal the provisions of the charter or bylaws with respect to:

the election of directors,

the right to call a special shareholders meeting,

provisions relating to the liability of our directors,

the provisions of the charter with respect to amendments to our charter or bylaws and

any provisions inconsistent with such provisions.

We are subject to anti-takeover provisions provided under the laws of Tennessee and other states, including the following:

Business Combination Statute. The Tennessee Business Combination Act, or the TBCA, provides that a party owning 10% or more of any class of outstanding voting stock in a resident domestic corporation is an interested shareholder. An interested shareholder cannot engage in a business combination with the resident domestic corporation unless the combination:

takes place at least five years after the interested shareholder first acquired 10% or more of the resident domestic corporation; and

is either approved by at least two-thirds of the non-interested voting shares of the resident domestic corporation or satisfies the fairness conditions of the TBCA.

A business combination with an entity can proceed without delay when approved by the target corporation s board of directors before that entity becomes subject to this restriction. The TBCA does not apply when the resident corporation has enacted a charter amendment or bylaw removing itself entirely from coverage under the TBCA. This charter amendment or bylaw must be approved by a majority of the shareholders who have held shares for more than one year before the vote and may not take effect for at least two years after the vote. We have not adopted a charter or bylaw amendment removing us from coverage under the TBCA.

Under the TBCA, officers and directors of resident domestic corporations who do not approve either proposed business combinations or charter amendments and bylaws removing their corporations from the TBCA s coverage cannot be held liable for this action as long as they held a good faith belief that the proposed business combination would adversely affect their corporation s employees, customers, suppliers, or the communities in which their corporation operates.

Control Share Acquisition Act. The Tennessee Control Share Acquisition Act, or the TCSAA, strips an acquiror s shares of voting rights any time an acquisition of shares in a covered Tennessee corporation brings an acquiror s voting power to prescribed maximum levels. Under the TCSAA, the acquiror s voting rights can be established only by a majority vote of the other shareholders. The acquiror may, upon submitting a control share acquisition statement, demand a meeting of shareholders to conduct this vote. The acquiror can demand a meeting before acquiring a control share only if it holds at least 10% of outstanding shares and announces a good faith intention to make the control share acquisition. Under the TCSAA, a target corporation has the option of redeeming an acquiror s shares if the shares are denied voting rights. The TCSAA applies only to a corporation that has adopted a provision in its charter or bylaws expressly declaring that the TCSAA will apply. We have not adopted any provision in our charter or bylaws electing protection under the TCSAA.

Tennessee and Other State Insurance Laws. Tennessee Insurance Law, or the TIL, applies to tender offers directed toward Tennessee domestic insurance companies, including any person controlling a Tennessee domestic insurance company. In general, the TIL requires any person seeking to acquire any voting security of a domestic insurance company, the result of which could, directly or indirectly cause such person to acquire control of such insurer, to file with the Tennessee Commissioner of Commerce and Insurance such information as required by the Commissioner before acquiring or making an offer to acquire such securities. Generally, these laws presume that control exists where any person, directly or indirectly, owns, controls, holds the power to vote or holds proxies representing 10% or more of our outstanding voting stock. Even persons who do not acquire beneficial ownership of more than 10% of the outstanding shares of our common stock may be deemed to have acquired such control if the Commissioner determines that such control exists in fact. Without the approval of the Commissioner, no such transaction may take place.

The Commissioner may call for public hearings after receiving a statement satisfying its requests. Whether or not a public hearing is held, the Commissioner may disapprove a transaction upon a finding that:

upon completion of the transaction, the domestic issuer would be unable to satisfy the requirements for the issuance of a license for the line or lines of insurance for which it is presently licensed;

the financial condition of the acquiring person is such as might jeopardize the financial stability of the insurer or prejudice the interests of other shareholders;

the plans or proposals the acquiring person has to change the business, corporate structure or management are unfair or prejudicial to policyholders; or

the competency, experience and integrity of those persons who would control the operation of the domestic insurer would not be in the public interest or in the best interest of the policyholders or shareholders.

In addition to owning an insurance subsidiary that is domiciled in Tennessee, we also own insurance subsidiaries that are domiciled, or otherwise considered to be domiciled, in each of the states of Delaware, Florida, Georgia, Louisiana, Mississippi, and South Carolina. Each of these states has laws that apply to tender offers that are similar to the TIL. A person cannot acquire 10% or more of the outstanding shares of our voting stock (5% or more for Florida), without the prior approval of the insurance commissioner or applicable state insurance regulatory authority of each of these other states.

Greenmail Act. The Tennessee Greenmail Act, or the TGA, applies to any corporation chartered under the laws of Tennessee, that has a class of voting stock registered or traded on a national securities exchange or registered with the Securities and Exchange Commission. The TGA provides that it is unlawful for any corporation to purchase any of its shares at a price above the market value from any person who holds more than 3% of the shares if the person has held those shares for less than two years. However, the TGA does allow the purchase if either:

the purchase is first approved by the affirmative vote of a majority of the outstanding shares of each class of voting stock issued; or

the corporation makes an equivalent offer, on a value per share basis, to all holders of the class of securities being purchased.

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Limitation of Liability and Indemnification

As permitted by Tennessee law, our charter provides that our directors shall not be personally liable to us or our shareholders for monetary damages for breach of fiduciary duty as a director, except for liability:

- for any breach of the director s duty of loyalty to us or our shareholders;
- for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or
- for any transaction from which the director derives an improper personal benefit.

As a result of this provision, we and our shareholders may be unable to obtain monetary damages from a director for a breach of the duty of care.

Our charter and bylaws provide for the indemnification of our directors and officers to the fullest extent authorized by Tennessee law, except that we will indemnify a director or officer in connection with an action initiated by that person only if the action was authorized by our board of directors. The indemnification provided under our charter and bylaws includes the right to be paid expenses in advance of any proceeding for which indemnification may be had.

Under our charter and bylaws, we have the power to purchase and maintain insurance on behalf of any person who is or was one of our directors, officers, employees or agents, or is or was serving at our request as a director, officer, employee, partner or agent of another corporation or of a partnership, joint venture, limited liability company, trust or other enterprise, against any liability asserted against the person or incurred by the person in any of these capacities, or arising out of the person s fulfilling one of these capacities. The insurance will also cover any expenses related to the liability. The insurance coverage is available to these persons whether or not we would have the power to indemnify the person against the claim under the provisions of Tennessee law. We have purchased director and officer liability insurance on behalf of our directors and officers.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is National City Bank.

Listing

Our common stock is listed on the Nasdaq National Market under the symbol DRCT .

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COMMON STOCK ELIGIBLE FOR FUTURE SALE

As of March 23, 2004, we had 21,657,655 shares of common stock outstanding. Other than shares held by our existing affiliates, as that term is defined in Rule 144 under the Securities Act, and without consideration of the contractual restrictions described below, all of our outstanding shares are freely transferable without restriction or further registration under the Securities Act. For purposes of Rule 144, an affiliate is a person that, directly or indirectly through one or more intermediaries, controls, or is controlled by or is under common control with, Direct General Corporation. Any shares held by our affiliates will be subject to the resale limitations of restricted stock as defined in Rule 144 under the Securities Act. As of March 23, 2004, 8,315,164 shares of our common stock were beneficially owned by our affiliates.

In general, under Rule 144 as currently in effect, a person who holds shares that were acquired from the issuer at least one year before is entitled to sell, within any three-month period, a number of shares that is not more than the greater of:

- 1% of the number of shares of common stock then outstanding; or

- the average weekly trading volume of the common stock on the Nasdaq National Market during the four calendar weeks before a notice of the sale on Form 144 is filed.

Sales under Rule 144 must also comply with manner of sale provisions and notice requirements and to the availability of current public information about us.

Under Rule 144(k), a person who has not been one of our affiliates at any time during the 90 days before a sale, and who holds shares that were acquired from the issuer at least two years before, is entitled to sell the shares without complying with the manner of sale, public information, volume limitation or notice provisions of Rule 144.

Subject to limitations on the aggregate offering price of a transaction and other conditions, Rule 701 may be relied upon regarding the resale of securities originally purchased from us by our employees, directors, officers, consultants or advisors before the date we become subject to the reporting requirements of the Exchange Act, under written compensatory benefit plans or written contracts relating to compensation of those persons. In addition, the Securities and Exchange Commission has indicated that Rule 701 will apply to the typical stock options granted by an issuer before it becomes subject to the reporting requirements of the Exchange Act, along with the shares acquired upon exercise of these options, including exercises after the date of this prospectus. Securities issued in reliance on Rule 701 are restricted securities and, subject to the contractual restrictions described below, may be sold (1) by persons other than our affiliates, subject only to the manner of sale provisions of Rule 144, and (2) by our affiliates under Rule 144 without compliance with its one-year requirement.

We have agreed that, without the prior written consent of Keefe, Bruyette & Woods, Inc. (KBW), we will not, during the period ending 90 days after the date of this prospectus:

- offer, sell, offer to sell, contract to sell, hedge, pledge, grant any option to purchase or otherwise transfer or dispose of, directly or indirectly, any shares of our common stock or any security convertible into or exercisable or exchangeable for our common stock or file any registration statement with respect to any such securities; or

- enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of our common stock,

whether any such transaction described above is to be settled by delivery of common stock or such other securities in cash or otherwise, except that we may issue shares of our common stock upon the exercise of currently outstanding options. All of our directors, executive officers and the selling shareholders, who collectively will beneficially own 6,984,533 shares of our common stock after this offering, have entered into the same agreement with KBW, subject to certain exceptions. William J. Harter, our Senior Vice President Corporate Development, Banking and Finance, and Ronald F. Wilson, our General Counsel and Secretary, have been granted exceptions to the standard agreement described above. During the 90-day period after the date of this prospectus, Mr. Harter may sell up to 12,000 shares of our common stock and Mr. Wilson may sell up to 28,000 shares of our common stock pursuant to a 10b5-1 plan he established under Rule 10b5-1(c) of the Securities Exchange Act of 1934.

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MATERIAL U.S. FEDERAL TAX CONSEQUENCES TO NON-U.S. SHAREHOLDERS

The following is a general summary of the material United States federal income and estate tax consequences expected to result under current law from the purchase, ownership and taxable disposition of shares of our common stock by a Non-U.S. Shareholder, which for the purpose of this summary is a person or entity who is not

- an individual who is a citizen or resident of the United States;
- a corporation or partnership created or organized in or under the laws of the United States or any state or political subdivision thereof, other than a partnership treated as a foreign person under U.S. Treasury regulations;
- an estate, the income of which is subject to United States federal income taxation regardless of its source; or
- a trust that (i) is subject to the primary supervision of a United States court and which has one or more United States fiduciaries who have the authority to control all substantial decisions of the trust, or (ii) has a valid election in effect under applicable United States Treasury regulations to be treated as a United States person.

This summary does not address all of the United States federal income tax and estate tax considerations that may be relevant to a Non-U.S. Shareholder in light of its particular circumstances or to Non-U.S. Shareholders that may be subject to special treatment under United States federal income tax laws. Furthermore, this summary does not discuss any aspects of state, local or foreign taxation. This summary assumes that a Non-U.S. Shareholder holds our common stock as a capital asset as determined for United States federal income tax purposes (generally property held for investment). This summary is based on current provisions of the Internal Revenue Code of 1986, as amended, Treasury regulations, judicial opinions, published positions of the Internal Revenue Service and other applicable authorities, all of which are subject to change or differing interpretations, possibly with retroactive effect.

Each prospective purchaser of our common stock is advised to consult its tax adviser with respect to the U.S. federal, state, local and foreign income and other tax consequences of acquiring, holding and disposing of our common stock.

Dividends

If distributions are paid on shares of our common stock, such distributions will constitute dividends for U.S. federal income tax purposes to the extent paid from our current or accumulated earnings and profits, as determined under U.S. federal income tax principles. If a distribution exceeds our current and accumulated earnings and profits, it will constitute a return of capital that is applied against and reduces, but not below zero, your adjusted tax basis in our common stock. Any remainder will constitute gain on the common stock. If we pay a dividend to a Non-U.S. shareholder, we will have to withhold United States federal withholding tax at a 30% rate (or such lower rate as may be specified by an applicable income tax treaty) from the gross amount of any dividend paid to a Non-U.S. Shareholder of our common stock, unless the dividend is effectively connected with the conduct of a trade or business of the Non-U.S. Shareholder within the United States. If the dividend is effectively connected with the conduct of a trade or business of the Non-U.S. Shareholder within the United States and if a tax treaty applies and is attributable to a United States permanent establishment of the Non-U.S. Shareholder, the dividend will not be subject to United States withholding tax if the Non-U.S. Shareholder files certain forms with the payor of the dividend, including Internal Revenue Service Form W-8ECI (or any successor form). Then the Non-U.S. Shareholder generally will be subject to United States federal income taxation on a net income basis in the same manner as if the Non-U.S. Shareholder were a resident of the United States. If the Non-U.S. Shareholder is a corporation, such effectively connected income may also be subject to an additional branch profits tax at the rate of 30% (or such lower rate as may be specified by an applicable income tax treaty) on the repatriation or deemed repatriation from the United States of its effectively connected earnings and profits, subject to certain adjustments and exceptions.

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Sale or Disposition of Common Stock

A Non-U.S. Shareholder generally will not be subject to United States federal income tax on any gain realized upon the sale or other disposition of our common stock unless (i) such gain is effectively connected with a United States trade or business of the Non-