DIRECT GENERAL CORP
Form 10-Q
August 08, 2006

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**
**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2006

or

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

For the transition period from ____________________ to _________________

Commission File Number: 000-50360

**DIRECT GENERAL CORPORATION**

(Exact name of registrant as specified in its charter)

| Tennessee | 62-1564496 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1281 Murfreesboro Road, Nashville, TN | 37217 |
| (Address of principal executive offices) | (Zip Code) |

(615) 399-0600

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 20,347,675 shares of common stock, no par value, at August 4, 2006.

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## PART I FINANCIAL INFORMATION

**Item 1. Financial Statements.**

**DIRECT GENERAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (In thousands - except per share amounts) | | | |
| **Revenues** | | | | |
| Premiums earned | $ 107,458 | $ 104,737 | $ 209,346 | $ 206,650 |
| Finance income | 11,091 | 12,130 | 22,854 | 24,301 |
| Commission and service fee income | 10,383 | 11,116 | 24,436 | 25,383 |
| Net investment income | 4,804 | 3,546 | 8,928 | 6,875 |
| Net realized gains (losses) on securities and other | 381 | (286) | (634) | (255) |
| Total revenues | 134,117 | 131,243 | 264,930 | 262,954 |
| **Expenses** | | | | |
| Insurance losses and loss adjustment expenses | 81,946 | 76,485 | 159,163 | 152,367 |
| Selling, general and administrative costs | 37,566 | 34,322 | 73,772 | 67,106 |
| Interest expense | 3,118 | 1,950 | 5,796 | 3,260 |
| Total expenses | 122,630 | 112,757 | 238,731 | 222,733 |
| Income before income taxes | 11,487 | 18,486 | 26,199 | 40,221 |
| Income tax expense | 4,335 | 6,990 | 9,887 | 15,142 |
| Net income | $ 7,152 | $ 11,496 | $ 16,312 | $ 25,079 |
| **Earnings per Share** | | | | |
| Basic earnings per common share | $ 0.35 | $ 0.53 | $ 0.80 | $ 1.14 |
| Diluted earnings per common share | $ 0.35 | $ 0.53 | $ 0.80 | $ 1.14 |

See notes to condensed consolidated financial statements.

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**DIRECT GENERAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| | (Unaudited) June 30, 2006 | December 31, 2005 |
|---|---|---|
| | (In thousands) | |
| **Assets** | | |
| Investments: | | |
| Debt securities available-for-sale at fair value (amortized cost $422,451 and $395,159 at June 30, 2006 and December 31, 2005, respectively) | $ 408,654 | $ 388,032 |
| Short-term investments and other invested assets | 4,604 | 3,688 |
| Total investments | 413,258 | 391,720 |
| Cash and cash equivalents | 71,853 | 64,527 |
| Finance receivables, net | 237,693 | 214,796 |
| Reinsurance balances receivable | 21,910 | 27,083 |
| Prepaid reinsurance premiums | 5,034 | 24,440 |
| Goodwill and other intangible assets, net | 31,621 | 31,621 |
| Deferred policy acquisition costs | 20,191 | 13,804 |
| Income taxes recoverable | 6,609 | 4,692 |
| Deferred income taxes | 21,928 | 21,915 |
| Property and equipment, net | 17,367 | 18,346 |
| Other assets | 23,663 | 28,068 |
| Total assets | $ 871,127 | $ 841,012 |
| **Liabilities and Shareholders Equity** | | |
| Loss and loss adjustment expense reserves | $ 136,234 | $ 131,408 |
| Unearned premiums | 238,938 | 214,715 |
| Reinsurance balances payable and funds held | 16,806 | 32,024 |
| Accounts payable and accrued expenses | 14,621 | 12,550 |
| Notes payable | 158,233 | 153,009 |
| Debentures payable | 41,238 | 41,238 |
| Capital lease obligations | 1,979 | 2,636 |
| Payable for securities | 119 | 3,187 |
| Other liabilities | 13,622 | 12,713 |
| Total liabilities | 621,790 | 603,480 |
| Shareholders equity | | |
| Common stock, no par; authorized shares 100,000.0; issued shares 20,347.7 and 20,339.2 at June 30, 2006 and December 31, 2005, respectively | 70,361 | 69,700 |
| Retained earnings | 186,465 | 171,780 |
| Accumulated other comprehensive (loss) income: | | |
| Net unrealized depreciation on investment securities | (8,968) | (4,633) |
| Net gain on cash flow hedge | 1,479 | 685 |

| | | |
|---|---|---|
| Total shareholders equity | 249,337 | 237,532 |
| Total liabilities and shareholders equity | $ 871,127 | $ 841,012 |

See notes to condensed consolidated financial statements.

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**DIRECT GENERAL CORPORATION AND SUBSIDIARIES**
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(Unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | **2006** | **2005** |
| | **(In thousands)** | |
| **Operating activities** | | |
| Net income | $ 16,312 | $ 25,079 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Net realized losses on securities and other | 634 | 255 |
| Depreciation and amortization | 4,431 | 3,334 |
| Deferred income taxes | 1,894 | (2,256) |
| Changes in operating assets and liabilities: | | |
| Finance receivables, net | (22,897) | (27,361) |
| Reinsurance balances receivable | 5,173 | 3,569 |
| Prepaid reinsurance premiums | 19,406 | 1,893 |
| Deferred policy acquisition costs | (6,387) | (1,348) |
| Income taxes recoverable/payable | (1,917) | 3,626 |
| Loss and loss adjustment expense reserves | 4,826 | 1,197 |
| Unearned premiums | 24,223 | 21,773 |
| Reinsurance balances payable and funds held | (15,218) | 2,456 |
| Accounts payable and accrued expenses | 2,071 | 3,852 |
| Other | 7,175 | 4,691 |
| Net cash provided by operating activities | 39,726 | 40,760 |
| **Investing activities** | | |
| Proceeds from sales and maturities of debt securities available-for-sale | 43,546 | 51,409 |
| Purchase of debt securities available-for-sale | (72,505) | (74,532) |
| Payable for securities | (3,068) | 9,494 |
| Net purchases of short-term investments | (938) | 40 |
| Purchase of property and equipment, net | (2,399) | (3,863) |
| Purchase of insurance agency assets | | (5,560) |
| Net cash used in investing activities | (35,364) | (23,012) |
| **Financing activities** | | |
| Repurchase of common stock | | (20,037) |
| Issuance of common stock | 23 | 557 |
| Net proceeds from borrowings | 6,543 | 43,800 |
| Payment of principal on borrowings | (1,975) | (766) |
| Payment of dividends on common stock | (1,627) | (1,749) |
| Net cash provided by financing activities | 2,964 | 21,805 |
| Net increase in cash and cash equivalents | 7,326 | 39,553 |
| Cash and cash equivalents at beginning of period | 64,527 | 70,988 |
| Cash and cash equivalents at end of period | $ 71,853 | $ 110,541 |

See notes to condensed consolidated financial statements.

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**DIRECT GENERAL CORPORATION AND SUBSIDIARIES**
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**(Unaudited)**

**1. Nature of Operations**

Direct General Corporation, headquartered in Nashville, Tennessee, is a financial services holding company whose principal operating subsidiaries provide non-standard personal automobile insurance, term life insurance, premium finance and other consumer products and services primarily on a direct basis and primarily in the southeastern United States. Direct General Corporation owns five property/casualty insurance companies, two life/health insurance companies, two premium finance companies, twelve insurance agencies, two administrative service companies and one company that provides non-insurance consumer products and services. (Direct General Corporation and its subsidiaries are sometimes collectively referred to herein as the Company. )

**2. Basis of Presentation**

The unaudited condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP) have been condensed or omitted pursuant to such rules and regulations. The unaudited condensed consolidated financial statements reflect all normal recurring adjustments which were, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. The results of operations for the period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the full year. These unaudited condensed consolidated financial statements and the notes thereto should be read in conjunction with the Company s audited financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

**3. Notes Payable**

The Company maintains a $190.0 million revolving credit facility with a consortium of banks to fund the working capital of the Company s premium finance operations. As of June 30, 2006, the amount outstanding under the facility was $156.5 million. Effective June 30, 2006, the Company and its banks agreed to an amendment of this credit facility to increase the aggregate amount available to $225.0 million effective January 1, 2007 and extend the maturity to June 30, 2009. Direct General Corporation also has a $30.0 million revolving credit facility available to support its operations and strategic initiatives. No amounts were outstanding under this facility as of June 30, 2006.

**4. Earnings Per Share**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| | (In thousands, except per share amounts) | | | |
| Numerator: | | | | |
| Net income | $ 7,152 | $ 11,496 | $ 16,312 | $ 25,079 |
| Denominator: | | | | |
| Weighted average common shares outstanding | 20,347.7 | 21,634.5 | 20,345.6 | 21,951.6 |
| Dilutive stock options | 37.9 | 48.4 | 39.6 | 75.4 |
| Weighted average common shares outstanding for purposes of computing diluted earnings per common share | 20,385.6 | 21,682.9 | 20,385.2 | 22,027.0 |
| Basic earnings per common share | $ 0.35 | $ 0.53 | $ 0.80 | $ 1.14 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Diluted earnings per common share | $ | 0.35 | $ | 0.53 | $ | 0.80 | $ | 1.14 |

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**5. Stock Options**

The Company has historically used and plans to continue to use stock options as a component of its overall compensation to employees. The Company may grant incentive stock options that qualify for certain favorable tax treatment under Section 422 of the Internal Revenue Code of 1986. It may also grant stock options that do not qualify for such favorable tax treatment. The Company grants employee incentive stock options at an exercise price equal to the market price at the date of grant.

Effective January 1, 2006, the Company adopted the provisions of the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, which was issued in December 2004 and is effective for periods beginning after June 15, 2005. This statement requires the Company to expense the cost resulting from all share-based payment arrangements, including employee stock options, in its financial statements. The Company adopted the provisions of this statement using the modified prospective approach. This approach requires that compensation expense to be recorded for all unvested stock options and restricted stock that exist upon adoption of the statement as they vest. New stock options that are granted are recognized as expense in the financial statements based on their fair values at the grant date. The Company recorded pre-tax compensation expense of $0.6 million for the first six months of 2006.

Prior to the adoption of the provisions of this statement, the Company followed the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, to account for its employee stock option activity in the financial statements.

If the accounting for compensation expense based on the fair value of stock options at the grant date as prescribed by SFAS No. 123 would have been in effect for prior periods, net income available to common shareholders and basic and diluted earnings per share would have been reported as presented in the following table.

| | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|
| | (In thousands, except per share amounts) | |
| Net income, as reported | $ 11,496 | $ 25,079 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects | (213) | (431) |
| Net income, pro forma | $ 11,283 | $ 24,648 |
| Income for purposes of computing diluted earnings per share common, as reported | $ 11,496 | $ 25,079 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method, net of related tax effects | (213) | (431) |
| Income for purposes of computing diluted earnings per share common, pro forma | $ 11,283 | $ 24,648 |
| Earnings per share | | |
| Basic as reported | $ 0.53 | $ 1.14 |
| Basic pro forma | $ 0.52 | $ 1.12 |

| | | | | |
|---|---|---|---|---|
| Diluted | as reported | $ 0.53 | $ 1.14 |
| Diluted | pro forma | $ 0.52 | $ 1.12 |

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A summary of the status of the Company s stock option plans as of June 30, 2006 and the components of the change for the period are as follows:

| | Number of Shares |
|---|---|
| Options outstanding January 1, 2006 (385,300 exercisable) | 970,700 |
| Granted | 50,000 |
| Exercised | 8,500 |
| Forfeited | 48,000 |
| Options outstanding June 30, 2006 (365,700 exercisable) | 964,200 |

The Company uses the Black-Scholes pricing model to calculate the fair value of the options awarded as of the date of grant based on the following factors:

| | 2006 | 2005 |
|---|---|---|
| Expected option term | 5 years | 5 years |
| Annualized volatility rate | 14%-21.0% | 31.5% |
| Risk-free rate of return | 4.57%-5.00% | 4.12% |
| Fair value at the date of grant | $ 15.57-$18.79 | $ 18.06 |
| Dividend yield | 0.63%-0.77% | 0.66% |
| Black-Scholes value | 22.9%-26.0% | 32.9% |

**6. Comprehensive Income**

Total comprehensive income was $5.8 million and $14.7 million for the three months ended June 30, 2006 and 2005, respectively, and $12.8 million and $24.9 million for the six months ended June 30, 2006 and 2005, respectively.

**7. Contingencies**

The Company is named as defendant in various legal actions arising in the ordinary course of business. In addition, the Company and certain of our officers and directors are named as defendants in a putative securities class action lawsuit and two shareholder derivative actions. The Company believes it has meritorious defenses to these actions and intends 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 the Company is 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 these cases.

**8. Recent Accounting Pronouncements**

The Company regularly reviews recent accounting pronouncements issued by the Financial Accounting Standards Board, American Institute of Certified Public Accountants, Emerging Issues Task Force, and Staff Accounting Bulletins issued by the United States Securities and Exchange Commission to determine the potential impact on the Company s financial statements. Based on its most recent review, the Company has determined that the majority of these recently issued accounting standards either do not apply to the Company or will not have a material impact on its financial statements.

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

*This Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company s discussion presented under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations that is available in the Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission.*

**Overview of Operating Results**

Net income for the three months ended June 30, 2006 was $7.2 million or $0.35 per share, on a diluted basis, as compared to net income of $11.5 million or $0.53 per share, on a diluted basis, in the second quarter of 2005. The second quarter results were influenced by increases in our loss and expense ratios that were partially offset by an increase in net investment income. The loss ratio for the second quarter of 2006 was 76.3% which included approximately 1.3 points related to storm losses in the period that were partially offset by 0.5 points of net favorable reserve development on prior year reserves. Comparatively, the loss ratio for the second quarter of 2005 was 73.0%, which included 0.4 points of net favorable reserve development. The increase in operating expenses included an increase in advertising, higher costs related to our expansions in Texas, Missouri and Virginia, and a higher level of interest expense. For the six months ended June 30, 2006, net income was $16.3 million or $0.80 per share, on a diluted basis, compared to $25.1 million or $1.14 per share in the corresponding period in 2005.

**Summary of Key Measures of Financial Results**

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.

| | (Unaudited) Three Months Ended June 30, | | | (Unaudited) Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| ($ in millions) | 2006 | 2005 | % Change | 2006 | 2005 | % Change |
| **Selected Financial Data** | | | | | | |
| Gross premiums written | $ 89.2 | $ 98.4 | (9.3) | $ 249.8 | $ 259.7 | (3.8) |
| Ancillary income | 21.4 | 23.2 | (7.8) | 47.3 | 49.7 | (4.8) |
| Net investment income | 4.8 | 3.6 | 33.3 | 8.9 | 6.9 | 29.0 |
| Gross revenues | $ 115.4 | $ 125.2 | (7.8) | $ 306.0 | $ 316.3 | (3.3) |
| Ceded premiums written | 0.6 | (11.4) | (105.3) | 3.2 | (29.4) | (110.9) |
| Change in net unearned premiums | 17.7 | 17.7 | 0.0 | (43.7) | (23.6) | 85.2 |
| Net realized gains (losses) on securities and other | 0.4 | (0.3) | NM | (0.6) | (0.3) | NM |
| Total revenues | $ 134.1 | $ 131.2 | 2.2 | $ 264.9 | $ 263.0 | 0.8 |
| Net income | $ 7.2 | $ 11.5 | (37.4) | $ 16.3 | $ 25.1 | (35.1) |
| **Key Financial Ratios** | | | | | | |
| Loss ratio net | 76.3% | 73.0% | | 76.0% | 73.7% | |
| Expense ratio net | 17.9% | 12.4% | | 15.4% | 10.0% | |

| | | | | |
|---|---|---|---|---|
| Combined ratio net | 94.2% | 85.4% | 91.4% | 83.7% |
| Ancillary income to gross premiums earned | 18.8% | 19.4% | 21.0% | 20.9% |
| Ancillary income to net operating expenses | 52.6% | 64.1% | 59.4% | 70.6% |

***Explanation of Key Measures***

We evaluate our operations by monitoring key measures of growth and profitability. We measure our growth by examining our gross revenues, which is 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. 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. 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 are the sum of gross premiums written plus ancillary income (finance income and commission and service fee income) and net investment income (excluding 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 Management s Discussion and Analysis of Financial Condition and Results of Operations Results of Operations .

*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 both 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 more accurately 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 (finance income and commission and service fee income) that reflect the major 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 insurance competitors only achieve point of sale contact through an independent agent and are therefore typically unable to generate significant amounts of ancillary income.

*Seasonality*. The months of February and March generally represent some of the highest premium production months of the year, as we believe many of our customers have more disposable cash as a result of income tax refunds. As a result, gross premiums written are generally the highest during the first quarter of the year. Typically, the Company generally experiences its lowest level of gross premiums written during the second quarter of the year as

cancellations on the business written in the first quarter occur. Since the majority of our business is financed, finance receivables and unearned premiums increase during the first quarter. In addition, there are corresponding increases in notes payable and cash as our premium finance subsidiaries draw on the revolving line of credit with our banks to settle balances due to our insurance subsidiaries. Since these settlements occur at the end of each month, our insurance subsidiaries tend to hold a high level of cash during the second quarter that has yet to be permanently invested in the long term portfolio.

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**Results of Operations**

***Revenues***

*Premiums*

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 presented:

| | (Unaudited) Three Months Ended June 30, | | | (Unaudited) Six Months Ended June 30, | | |
|---|---|---|---|---|---|---|
| ($ in millions) | 2006 | 2005 | % Change | 2006 | 2005 | % Change |
| Gross premiums written | | | | | | |
| Florida | $ 41.2 | $ 46.6 | (11.6) | $ 112.2 | $ 124.7 | (10.0) |
| Tennessee | 10.7 | 12.5 | (14.4) | 30.4 | 34.8 | (12.6) |
| Texas | 10.1 | 14.5 | (30.3) | 25.0 | 23.0 | 8.7 |
| Georgia | 5.2 | 5.5 | (5.5) | 16.5 | 16.1 | 2.5 |
| Louisiana | 5.0 | 5.3 | (5.7) | 13.8 | 17.1 | (19.3) |
| Mississippi | 5.8 | 5.0 | 16.0 | 17.0 | 15.0 | 13.3 |
| All other states | 11.2 | 9.0 | 24.4 | 34.9 | 29.0 | 20.3 |
| Gross premiums written | $ 89.2 | $ 98.4 | (9.3) | $ 249.8 | $ 259.7 | (3.8) |
| Ceded premiums written | 0.6 | (11.4) | (105.3) | 3.2 | (29.4) | (110.9) |
| Net premiums written | $ 89.8 | $ 87.0 | 3.2 | $ 253.0 | $ 230.3 | 9.9 |
| Gross premiums earned | $ 114.0 | $ 119.7 | (4.8) | $ 225.7 | $ 237.9 | (5.1) |
| Ceded premiums earned | (6.5) | (15.0) | (56.7) | (16.4) | (31.2) | (47.4) |
| Net premiums earned | $ 107.5 | $ 104.7 | 2.7 | $ 209.3 | $ 206.7 | 1.3 |
| Net premiums written to gross premiums written | 100.7% | 88.4% | | 101.3% | 88.7% | |
| Gross premiums earned to gross premiums written | 127.8% | 121.6% | | 90.4% | 91.6% | |
| Net premiums earned to net premiums written | 119.7% | 120.3% | | 82.7% | 89.8% | |

Gross premiums written decreased $9.2 million or 9.3% for the three months ended June 30, 2006 compared to the second quarter of 2005. For the second quarter of 2006, gross premiums written from the sale of our core non-standard automobile insurance business decreased 9.7% to $85.3 million, while gross premiums written from the sale of our term life insurance business remained unchanged at $3.9 million. Gross premiums earned, a function of gross premiums written over the current and prior periods, decreased 4.8% to $114.0 million in the second quarter of 2006 from $119.7 million in the same period in 2005. However, because we elected to eliminate our quota share reinsurance beginning in 2006, the higher retention resulted in a 2.7% increase in net earned premiums over the second quarter of 2005.

Gross premiums written in Texas decreased 30.3% to $10.1 million in the second quarter 2006 as compared to $14.5 million in the corresponding quarter for 2005. This decline is directly attributable to our conversion to annual policies in Texas and is not indicative of current trends. We started our conversion to annual policies in Texas in late March 2005 and, as a result, the second quarter 2005 premium volumes that included the impact of annual premiums

were only offset by a minimal amount of cancellations because all prior business was monthly policies. Conversely, the premium volumes in second quarter 2006 were net of $7.0 million in cancelled premiums. We expect the cancellation rate on the Texas annual policies to be similar to our remaining states at approximately 50.0%.

Our conversion to annual policies is stabilizing and currently, approximately 73.6% of our Texas book of business was written for an annual term. We expect to continue to offer monthly policies and believe that monthly policies will ultimately represent between 20.0% and 25.0% of the Texas book. We also expect the Texas premium volumes to grow in excess of 10.0% during the second half of the year as compared to the third and fourth quarters of 2005.

Gross premiums written in the other expansion states of Missouri and Virginia totaled $2.3 million in the second quarter of 2006 as compared to $0.4 million in the quarter for 2005. We expect to continue to gain market share in each of these states over the course of the year as we continue to develop our brand through advertising within these states. Our initial sales office development in these states is now complete, with 25 offices in Missouri and 22 offices in Virginia.

Gross premiums written in Florida declined 11.6% to $41.2 million while premiums in Tennessee declined 14.4% to $10.7 million as compared to the second quarter of 2005. Our hit ratios in these markets remain very good, but we continue to experience declines in quotes, thus driving down our new business policies. Overall, we believe that we remain competitive in these markets for our core customer; however, as with most of our states, we believe that the increased advertising and a focus on the higher credit profiles of the nonstandard market by some of the national carriers has resulted in our gross written premium declines. The percentage of polices that renew with us at the end of their term remains strong; however, the percentage of policies making it to term has declined in both states. We believe that this could also be a result of some declines in the top tier of our customer base. We recently implemented new rate structures for Florida and Tennessee and are in the process of implementing a more sophisticated pricing structure to help us compete in the upper tiers of the nonstandard market for all of our states.

The pursuit of alternative distribution channels remains a key strategic initiative. In an effort to expand penetration in our core markets, we will be implementing our Rural Independent Agent Program in the last quarter of this year in Tennessee with plans to roll it out in other states if it delivers results as expected. Specifically, we plan to offer our term life and nonstandard automobile insurance products through independent agents in the rural markets of the states in which we operate. At this time, we are focusing on rural markets where the size of the market generally precludes us from opening our own sales office. Based on our preliminary discussions with independent agents, we believe this program will be favorably received by the independent agents due, in large part, to our name recognition, our ongoing advertising efforts and the competitively priced products we are offering in these markets.

We are now selling policies over the telephone in all of our markets. This distribution channel not only gives us the added flexibility of binding insurance over the phone, but also gives us an alternative channel to expand into new geographic markets. Quoting over the Internet on our website is also available in all of our markets. In addition to Internet sales through our third party Internet provider in Florida, we have begun to sell policies over the Internet through our website in Tennessee. We plan on expanding Internet sales to all of our remaining markets by the end of this year.

We plan to expand into Illinois in the fourth quarter of this year followed closely by Pennsylvania. Our plans are to primarily utilize our phones sales and Internet initiatives to enter these markets thus limiting the fixed costs associated with new state expansion.

*Ancillary Income*

Ancillary income for the three months ended June 30, 2006 decreased 7.8% to $21.4 million compared to the corresponding period in 2005. Finance income decreased 8.6% to $11.1 million in the second quarter of 2006 as compared to the same period in 2005 due to the 4.8% decline in gross premiums earned and a shift of the mix of business to states where the premium finance yield is slightly lower. Commission and service fee income declined 6.6% in the second quarter of 2006. We receive administrative service fees for the agency, underwriting, policy administration and claims adjusting services performed on behalf of unaffiliated insurers, including nonstandard automobile insurance in Texas and North Carolina. In 2005, we commenced underwriting a portion of our Texas business through one of our own insurance subsidiaries. As a result, the volume of Texas business serviced by us, but underwritten by an unaffiliated insurer declined, which reduced our administrative service fee income by approximately $0.5 million in the current quarter. In addition, we experienced a $0.2 million reduction in commission and administrative service fees from the sale of ancillary insurance products that was partially offset by a $0.1 million increase in income from the sale of our Direct Prepaid Visa® debit card.

The ratio of ancillary income to gross premiums earned was 18.8% and 21.0% for the three and six months ended June 30, 2006, respectively, as compared to 19.4% and 20.9% for the corresponding periods in 2005. For these same periods, the ratio of ancillary income to operating expenses decreased to 52.6% and 59.4% in the 2006 periods, respectively, from 64.1% and 70.6% in the 2005 periods. Because operating expenses are net of ceded reinsurance commissions received and because we have been reducing our level of reinsurance, our net operating expenses have increased, resulting in a lower ratio of ancillary income to operating expenses. In addition, ancillary income growth was impacted by the fact that there are currently no third party ancillary insurance products available for us to sell through our Texas and Virginia agents.

*Net Investment Income*

Net investment income was $4.8 million for the three months ended June 30, 2006 compared to $3.5 million for the second quarter of 2005. The increase was due primarily to an increase in average invested assets and a higher investment yield as a result of the increasing interest rate environment and slightly longer portfolio duration. Average invested assets increased 20.7% to $409.9 million in the second quarter of 2006 from $339.6 million in the second quarter of 2005. The annualized investment yield was 4.7% and 4.1% for the three months ended June 30, 2006 and 2005, respectively. The increase in the annualized yield rate reflects the higher yield rates on the floating rate securities in the portfolio, and the investment of new cash flows in higher yielding securities in this rising interest rate environment.

*Realized Gains on Securities and Other*

We realized no gross gains and $0.3 million of gross losses on the sale of securities for the three months ended June 30, 2006. Comparatively, we realized gross gains on debt securities of $0.1 million and gross losses of $0.4 million for the comparable period in 2005. There was no impact on realized losses attributable to adjustments for other than temporary impairment of securities still held during either of these periods.

In the second quarter of 2006, we also realized gross gains of $1.3 million and gross losses of $1.8 million on closed contracts in our trading portfolio. The comparable amounts for the second quarter of 2005 were gross gains of $1.0 million and gross losses of $0.4 million. 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 condensed consolidated statement of operations. During the quarter, the market value on open contracts increased by $1.2 million, which was included in net realized gains (losses) on securities and other , as compared to a decrease of $0.5 million in the prior year. As of June 30, 2006, we had open contracts with gross unrealized gains of $1.0 million and gross unrealized losses of $0.6 million. In the aggregate, the trading portfolio had a net realized gain of $0.7 million in the second quarter of 2006 as compared to no net realized gain in the second quarter of 2005.

***Expenses***

*Insurance Losses and Loss Adjustment Expenses*

Insurance losses and loss adjustment expenses increased to $81.9 million for the three months ended June 30, 2006 from $76.5 million for the same period in 2005. The loss ratio for the second quarter of 2006 was 76.3%, which included 1.3 points of storm losses primarily related to tornadoes and hailstorms that hit Tennessee, Texas and other southeastern states in April and May. The loss ratio for the second quarter of 2005 was 73.0%. The Company s quarterly analysis of reserves resulted in a net decrease to prior accident quarters reserves of $0.5 million, which decreased the net loss ratio by 0.5 points in the second quarter of 2006, as compared to a favorable reserve development of 0.4 points in the corresponding quarter for 2005. The majority of our favorable reserve development of $0.5 million in the current quarter related to lower than expected ultimate frequency for personal injury protection losses in Florida and a reduction in ultimate frequency and severity on bodily injury and property damage losses in Tennessee. These reserve adjustments were generally related to the 2005 accident year.

The net loss ratios, excluding the impact of the adjustments to prior years reserves, were 75.5% and 73.4% for the three months ended June 30, 2006 and 2005, respectively. The increase in the current accident quarter loss ratio is compared to the second quarter of 2005 was generally related to some increases in expected ultimate severity in the bodily injury and property damage coverages that started to occur in the second half of 2005. We believe these increases relate to inflationary trends for health care and increased labor rates for vehicle repairs. The frequency for the personal injury protection coverage is slightly lower than the second quarter of 2005, but has remained fairly stable for the past three quarters.

*Operating Expenses*

Operating expenses increased 12.1% to $40.7 million for the three months ended June 30, 2006, compared to $36.3 million for the same period of 2005. This increase in operating expenses reflected increased advertising costs, interest expense, and a lower level of ceding commissions received from reinsurers. Advertising increased by $1.8 million, more than half of which can be attributed to advertising in our expansion states of Texas, Missouri, and Virginia. In addition, the increase in operating expenses also reflected a $1.4 million reduction in ceded reinsurance commissions received compared to the same period in 2005. The impact of the increase in advertising and the lower level of ceding commissions was partially offset by an increase in deferred policy acquisition costs. Interest expense increased $1.2 million, which is due to both an increased interest rate environment and $0.8 million of interest on our $40.0 million junior subordinated debentures that were issued in the third quarter of 2005.

The increase in operating expenses resulted in net expense ratios of 17.9% and 15.4% for the three and six months ended June 30, 2006, respectively, as compared to 12.4% and 10.0%, respectively, for the corresponding periods in 2005. Our expansion states continue to have a significant impact on this ratio, increasing it by approximately four to five percentage points during 2006. However, we expect this impact will decline as we gain

scale and maturity in these states.

*Income Taxes*

Income tax expense decreased to $4.3 million in the second quarter of 2006 as compared to $7.0 million in the second quarter of 2005 due to the reduction in pretax income. Our effective tax rates remained fairly consistent at 37.7% and 37.8% for the three-month periods ended June 30, 2006 and 2005, respectively.

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## 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 companies 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.

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 $39.7 million and $40.8 million in the first six months of 2006 and 2005, respectively. We expect our cash flows to be positive in both the short-term and reasonably foreseeable future.

*Financing and Capital*

Although we have authorization from our board of directors to repurchase an additional $10.0 million shares of common stock through the end of January 2007 as part of our overall capital management strategies, we made no repurchases throughout the first six months of 2006. During this same period, we paid common stock dividends totaling $1.6 million.

As of June 30, 2006, the maximum aggregate amount available under our revolving credit agreement used to support our premium finance operations was $190.0 million and the amount outstanding was $156.5 million. We have recently negotiated the extension of the maturity date of this facility from June 2007 to June 2009. As a part of that extension, there will be an increase of the maximum amount to $225.0 million effective January 1, 2007. With these revisions, we believe that this facility is sufficient to support our premium finance operations through that time period.

*Reinsurance*

Our quota share reinsurance was eliminated for new and renewal business effective January 1 2006. Because of reinsurance on cancellation of premiums written in the prior year, ceded premiums resulted in additional net premiums written of 0.7% and 1.3% for the three and six months ended June 30, 2006, respectively. Comparatively, we ceded 11.6% and 11.3%, respectively, of our gross premiums written to third party reinsurers in the corresponding periods in 2005. We continue to maintain a property catastrophe reinsurance agreement that provides for $13.0 million of reinsurance coverage in excess of our $2.0 million retention per occurrence.

*Investments*

*Debt securities*. Our investment portfolio primarily consists of debt securities, all classified as available-for-sale and carried at market 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 June 30, 2006, our investment portfolio of $413.3 million included $13.8 million in net unrealized losses.

As of June 30, 2006, our investment portfolio included gross unrealized gains of $0.2 million and gross unrealized losses of $14.0 million. During the quarter, net unrealized losses on our investment portfolio increased by $2.6 million, which is included in accumulated other comprehensive (loss) income, net of applicable taxes, in the stockholders equity section of the balance sheet. Our quarterly procedures include an examination of 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. There were no such write downs in the first six months of either year.

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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.

The following table shows the composition by our internal industry classification of the amortized cost, gross unrealized gains, gross unrealized losses and fair value of debt securities available-for-sale as of June 30, 2006:

| ($ in millions) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses Less than 12 months | Gross Unrealized Losses Greater than 12 months | Fair Value |
|---|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 85.8 | $ | $ 1.8 | $ 1.0 | $ 83.0 |
| Obligations of states and political subdivisions | 70.8 | 0.2 | 0.7 | 0.5 | 69.8 |
| Corporate debt securities | | | | | |
| Banks and financial institutions | 103.7 | | 2.0 | 2.2 | 99.5 |
| Credit cards and auto loans | 82.2 | | 0.9 | 1.1 | 80.2 |
| Industrial | 47.6 | | 0.9 | 1.4 | 45.3 |
| Telecommunications | 17.5 | | 0.4 | 0.4 | 16.7 |
| Utilities and Electric Services | 14.9 | | 0.4 | 0.3 | 14.2 |
| Corporate debt securities | 265.9 | | 4.6 | 5.4 | 255.9 |
| Total | $ 422.5 | $ 0.2 | $ 7.1 | $ 6.9 | $ 408.7 |

The amortized cost and fair value of debt securities available-for-sale as of June 30, 2006, by contractual maturity, is shown below:

| ($ in millions) | Amortized Cost | Fair Value |
|---|---|---|
| Years to maturity: | | |
| One or less | $ 12.2 | $ 12.1 |
| After one through five | 188.2 | 182.8 |
| After five through ten | 132.7 | 127.4 |
| After ten | 89.4 | 86.4 |
| Total | $ 422.5 | $ 408.7 |

The Securities Valuation Office of the National Association of Insurance Commissioners ( 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 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, rated BBB- or higher by Standard & Poor s ( S&P ). NAIC designations 3 through 6 include bonds considered 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 June 30, 2006. 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 June 30, 2006 was as follows:

($ in millions)

| NAIC Rating | S&P Rating | Amortized Cost | Fair Value | % |
|---|---|---|---|---|
| 1 | AAA | $ 154.4 | $ 150.5 | 36.8% |
| 1 | AA | 33.6 | 32.7 | 8.0% |
| 1 | A | 111.1 | 106.7 | 26.2% |
| 2 | BBB | 37.8 | 36.1 | 8.8% |
| 1 | Agency | 85.6 | 82.7 | 20.2% |
| Total | | $ 422.5 | $ 408.7 | 100.0% |

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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 is limited 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.

The following table provides information about our investments that are sensitive to interest rate risk and provides estimates of expected changes in fair value based upon a 100 basis-point increase and decrease in market interest rates as of June 30, 2006:

| ($ in millions) | -100 Basis Point Change | Fair Value | +100 Basis Point Change |
|---|---|---|---|
| Debt securities, available-for-sale | $ 423.1 | $ 408.7 | $ 394.3 |

*Short-term investments.* We have a managed trading account with a commodities trading company and, as of June 30, 2006, the total fair value of open trades in this account was a $0.4 million gain, which represents less than 1% of our entire investment portfolio. We invest in commodities, primarily cattle futures and swaps. U.S. Treasury securities of $2.6 million, included in short-term investments and cash of $2.2 million, included in cash and cash equivalents, are held as collateral for this account. We recognized a net realized loss of $0.5 million on closed contracts and a $1.2 million gain on open contracts during the second quarter of 2005. Because this is a speculative investment and not a hedge, both the realized gains on closed contracts and the change in the fair value of open contracts are reported as net realized gains (losses) on securities and other in our consolidated statement of operations.

*Cash and cash equivalents*. Our balance in cash and cash equivalents was $71.9 million as of as of June 30, 2006, which was 11.4% higher than the balance of cash held at December 31, 2005. This balance fluctuates as net cash flows from operations are in the process of being permanently invested in our long-term bond portfolio.

**Forward-Looking Statements**

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements made in the report, other than statements of historical fact, are forward-looking statements. You can identify these statements from our use of the words may , should , could , potential , continue , plan , forecast , estimate , project , belie anticipate , expect , target , is likely , will , or the negative of these terms, and similar expressions. These statements 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 Business Risks Related to our Business section of the Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on March 15, 2006.

You should not place undue reliance on any forward-looking statements. These statements speak only as of the date of this report. 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 report, whether as a result of new information, future events, changed circumstances or any other reason after the date of this report.

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

Please see the caption Financial Condition Liquidity and Capital Resources in Part I FINANCIAL INFORMATION, Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations of this report for a description of our quantitative and qualitative disclosures about market risks.

**Item 4. Controls and Procedures.**

Our management, with the participation of our chief executive officer and chief financial officer, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this report. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective to ensure that material information relating to us and our consolidated subsidiaries is made known to such officers by others within these entities, particularly during the period this quarterly report was prepared, in order to allow timely decisions regarding required disclosure. There have not been any changes in our internal control over financial reporting during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II    OTHER INFORMATION

### Item 1. 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, we and one or more of our subsidiaries have been named as a defendant in a number of currently pending putative class action lawsuits. For descriptions of these legal actions, please see the caption   Business    Legal Proceedings   included in our Annual Report on Form 10-K for the year ended December 31, 2005 (   Form 10-K   ) filed with the Securities and Exchange Commission (   SEC   ) on March 15, 2006 and our periodic reports filed with the SEC under the Securities Exchange Act of 1934 since the filing of our Form 10-K. Our motions to dismiss all claims in the putative federal class action lawsuits and federal and state derivative actions described in our Form 10-K have been denied, and plaintiffs   motions for class certification in the federal class action are pending.

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

On May 3, 2006, we held the annual meeting of our stockholders to vote on the election of directors. The common stockholders voted to elect two directors to serve until the 2009 annual meeting of stockholders. Our common stockholders re-elected Raymond L. Osterhout to the Board of Directors by a vote of 18,004,895 for, 373,230withheld and 0 abstentions and broker non-votes. Our common stock holders also re-elected Stephen L. Rohde to the Board of Directors by a vote of 18,005,895 for, 372,230 withheld, and 0 abstentions and broker non-votes.

William C. Adair, Jr., Jacqueline C. Adair and Fred H. Medling continue to serve as members of the Board of Directors.

### Item 5. Other Information.

On August 8, 2006, we amended the revolving credit facility agreements among Direct General Financial Services, Inc. and Direct General Premium Finance Company, as borrowers, Direct General Corporation, certain of our other subsidiaries, and a consortium of banks of which First Tennessee Bank National Association serves as   Agent   (the   Credit Facility   ). The Credit Facility funds the working capital needs of our premium finance operations.

The Credit Facility was amended primarily to extend loan maturity, to increase the loan principal, and to admit MidFirst Bank, N.A., into the bank consortium. The amended Credit Facility maintains the $190,000,000 line of credit that is available to our premium finance operations through January 1, 2007, at which time the lenders   commitment under the Credit Facility will increase to $225,000,000. We pay a 0.2% annual fee for the amount of the lenders aggregate commitment that we do not use, except that from January 1, 2007 through December 1, 2007, that fee will be based only on the unused portion of $200,000,000 of the total commitment. Interest remains payable quarterly at a rate elected by us of either the base commercial rate of First Tennessee Bank National Association or at 1.5% to 2.0% above LIBOR, with the percentage established on the basis of our Loan Amount to Net Worth ratio, as defined in the loan agreement. Remaining interest and principal is payable in full at maturity. Loan maturity is extended from June 30, 2007 to June 30, 2009.

The Credit Facility is principally secured by the finance receivables of our premium finance subsidiaries, is guaranteed by Direct General Corporation and includes a pledge of the capital stock of each of our directly owned subsidiaries.

The Credit Facility loan agreement contains events of default and acceleration of payment obligations that are usual and customary for revolving credit facilities of this nature, such as failure to timely pay amounts due, breach of financial covenants, and the occurrence of a change in control.

### Item 6. Exhibits.

| | |
|---|---|
| 10.1 | Eighth Amendment to Eighth Amended and Restated Loan Agreement |

| | |
|---|---|
| 10.2 | Fifteenth Amended and Restated Guaranty Agreement |
| 10.3 | Seventh Amendment to Seventh Amended and Restated Pledge and Security Agreement |
| 10.4 | Seventh Amendment to Seventh Amended and Restated Security Agreement |

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|---|---|
| 31.1 | Rule 13a-14(a) Certifications of CEO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002). |
| 31.2 | Rule 13a-14(a) Certifications of CFO (pursuant to Section 302 of the Sarbanes-Oxley Act of 2002). |
| 32.1 | Rule 1350 Certifications of CEO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002). |
| 32.2 | Rule 1350 Certifications of CFO (pursuant to Section 906 of the Sarbanes-Oxley Act of 2002). |

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## SIGNATURES

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

| | | |
|---|---|---|
| | | DIRECT GENERAL CORPORATION<br>(Registrant) |
| August 8, 2006 | By: | /s/ William C. Adair, Jr. |
| Date | | (Signature) |
| | Name: | William C. Adair, Jr. |
| | Title: | Chairman and Chief Executive Officer |
| August 8, 2006 | By: | /s/ J. Todd Hagely |
| Date | | (Signature) |
| | Name: | J. Todd Hagely |
| | Title: | Senior Vice President and Chief Financial Officer |

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