

REPORT ON EXAMINATION
OF THE
DIRECT INSURANCE COMPANY
NASHVILLE, TENNESSEE

AS OF
DECEMBER 31, 2005

THE DEPARTMENT OF COMMERCE AND INSURANCE

STATE OF TENNESSEE
NASHVILLE, TENNESSEE

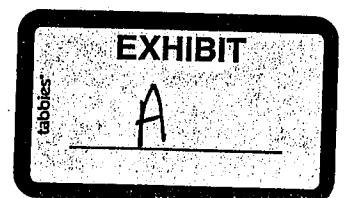


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Nashville, Tennessee
June 8, 2007

The Honorable Alfred W. Gross
Chairman, NAIC Financial
Condition (E) Committee
Secretary, Southeastern Zone, NAIC
Virginia Bureau of Insurance
P. O. Box 1157
Richmond, Virginia 23218-1157

The Honorable Leslie Newman
Commissioner of Commerce & Insurance
State of Tennessee
500 James Robertson Parkway
Nashville, 37243

Dear Commissioners:

Pursuant to your instructions and in accordance with the Tennessee Insurance Laws, regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a financial examination and market conduct review has been made concerning the conditions and affairs of the

DIRECT INSURANCE COMPANY
NASHVILLE, TENNESSEE

hereinafter generally referred to as the "Company" and a report thereon is submitted as follows:

INTRODUCTION

This examination was arranged by the Tennessee Department of Commerce and Insurance ("Department") and commenced on May 8, 2006. The examination was conducted under the association plan of the NAIC by duly authorized representatives of the Department. Concurrent with the examination of the Company, the South Carolina Department of Insurance examined the Company's subsidiaries, Direct General Insurance Company and Direct General Life Insurance Company, and the Georgia Department of Insurance examined Direct Life Insurance Company.

SCOPE OF EXAMINATION

This examination covers the period from January 1, 2002 through December 31, 2005, and includes any material transactions or events occurring subsequent to the examination date which were noted during the course of examination. The examination was conducted at the Company's office at 1281 Murfreesboro Road, Nashville, Tennessee 37217.

The examination of the financial condition was conducted in accordance with guidelines and procedures contained in the *NAIC Financial Condition Examiners Handbook*. During the course of the examination, assets were verified and valued and liabilities were determined or estimated as of December 31, 2005. The Company's financial

condition and its degree of solvency were thereby established. Test checks, covering selected periods, were made of income and disbursement items and a general review was made of the Company's operations, practices and compliance with statutes, to the extent hereinafter set forth. All asset and liability items contained in the financial statement of this report were examined and verified with relative emphasis according to their amounts and potential impact on surplus as regards policyholders.

Additionally, an examination of the following items was made:

- Previous Examination Recommendations
- Company History
- Growth of Company
- Charter and Bylaws
- Management and Control
- Corporate Records
- Holding Company System
- Agreements with Parent, Subsidiaries and Affiliates
- Fidelity Bond and Other Insurance
- Employee Benefits and Pension Plans
- Territory and Plan of Operation
- Market Conduct Activities
- Loss Experience
- Reinsurance Agreements
- Litigation and Contingent Liabilities
- Statutory Deposits
- Accounts and Records
- Loss Reserves
- Subsequent Events
- Financial Statements

These will be discussed as follows:

Previous Examination Recommendations:

The previous full scope examination was made as of December 31, 2001. Its corresponding "Order Adopting Examination Report with Modification and Directives" instructed the Company to correct four issues. These issues were reviewed and it was found that the Company has complied with the Department's directives concerning the prior examination report. Following is a description of the four issues:

1. *The Company is DIRECTED to comply with Tenn. Code Ann. § 56-3-103 by prohibiting any officer or director of the Company from accepting, or being the beneficiary of, either directly or remotely, any fee, brokerage, commission, gift or other consideration for or on account of any loan, deposit, purchase, sale, payment, or exchange made by or in behalf of such company, or be pecuniarily interested in any purchase, sale, or loan, either as borrower, principal, coprincipal, agent, or beneficiary.*

It appears that the Company has complied with this directive by requiring the Company officers who were also officers of affiliated agencies, to resign their positions with the affiliated agencies.

2. *The Company is DIRECTED to comply with Tenn. Code Ann. § 56-11-206 and Tenn. Comp. R. & Regs. Tit. Dept. of Commerce and Ins., ch. 0780-1-67 by obtaining the Commissioner's prior approval for any and all transactions within the holding company system that require such approval under Tenn. Code Ann. § 56-11-206(a)(2). The Company is further DIRECTED to file all such agreements currently in existence with the Commissioner and that have not yet received the Commissioner's approval.*

It appears that the Company has complied with this directive by filing the agreements that had not received approval, and by requesting prior approval for such transactions during the current examination period.

3. *The Company is DIRECTED to comply with Tenn. Comp. R. & Regs. Tit. Dept. of Commerce and Ins., ch. 0780-1-46 by maintaining a custodial agreement that complies with said rule, should the Company choose an authorized method of holding its securities that requires such an agreement.*

The Company amended their agreement with U.S. Bank prior to completion of the previous examination, as noted in the prior Report of Examination. That agreement is still in effect.

4. *The Company is DIRECTED to comply with the conditional approval granted by the Department on December 9, 1996, including but not limited to the valuation of the stock of its subsidiaries.*

As noted in the prior report, the Company corrected the valuation of its subsidiary beginning with the March 31, 2002 quarterly statement.

COMPANY HISTORY

The Company was originally incorporated on November 8, 1990. The Charter of Incorporation was filed with the Tennessee Secretary of State on April 10, 1991, and the Tennessee Department issued a Certificate of Authority on April 11, 1991, which licensed the Company as a stock property and casualty insurer. The Company commenced business on April 12, 1991, as Direct Insurance Company, Nashville, Tennessee.

At incorporation, the Company was authorized to issue forty thousand (40,000) shares of common capital stock with a par value of one hundred dollars (\$100) per share. Eleven thousand (11,000) shares were issued and outstanding at April 10, 1991. From that date through 1994, the Company continued to issue additional shares to various individuals, trusts and business entities until December 2, 1994, when all sixteen thousand, seven hundred ninety-four and one-half (16,794.5) outstanding shares were acquired by "Direct Corporation," which was the name stated on the stock certificate. In

1996, the Company's parent company changed its name from Direct Corporation to Direct General Corporation (DGC). In the December 31, 1997 examination report it was recommended that the name on the stock certificate be amended to reflect the parent's correct name. On March 14, 2000, the aforementioned stock certificate was replaced with a new certificate to reflect the correct corporate name.

The Company writes nonstandard private passenger automobile insurance in Tennessee and Arkansas. Affiliated insurance agencies sell the Company's products directly through neighborhood sales offices.

On December 17, 1998, the Company increased its surplus by \$2,000,000 in the form of gross paid in and contributed surplus. A summary of the Company's capitalization since incorporation is presented as follows:

	Number of Authorized Shares	Par Value	Shares Issued and Outstanding	Capital Stock	Paid-In Surplus
Balance, April 11, 1991	40,000	100	11,000.00	\$1,100,000	\$1,100,000
Additional stock issued during 1992			15,094.50	1,509,450	2,232,850
Additional stock issued during 1993			16,594.50	1,659,450	2,642,850
Additional stock issued during 1994			16,794.50	1,679,450	4,662,850
Increase in par value, December 31, 1996		150	16,794.50	2,519,175	9,823,125
Increase in paid-in, December 17, 1998			16,794.50	2,519,175	11,823,125
Balance, December 31, 2005			16,794.50	2,519,175	11,823,125

GROWTH OF COMPANY

The following exhibit depicts certain aspects of the growth and financial history of the Company for the period subject to this examination according to its annual statements as filed with the Tennessee Department of Commerce and Insurance:

Year	Premiums Earned	Losses Incurred	Assets	Liabilities	Capital & Surplus
2002	37,621,679	22,369,861	71,519,699	53,959,470	17,560,229
2003	47,247,671	29,908,517	76,610,684	56,078,896	20,531,788
2004	60,861,885	39,375,349	83,916,841	60,813,407	23,103,434
2005	67,678,198	42,411,728	88,975,314	62,056,079	26,919,235

CHARTER AND BYLAWS

Charter:

The original Charter of the Company was approved by the Department and effected April 10, 1991. An amended and restated Charter was filed with the Secretary of State on July 3, 2000. The Charter was again amended and restated on June 26, 2003, after being approved by the Department on June 17, 2003.

The Charter provides for the operation of a property and casualty insurance company that is for profit, and establishes its location in Nashville, Tennessee. The Charter in effect at the examination date states that:

The purpose for which the Corporation is organized is to engage in the business of a multiple line insurance company, writing and issuing policies of casualty insurance, as defined in section 56-2-201(2) of the Tennessee Code Annotated, and property insurance, as defined in the Tennessee Code Annotated Section 56-2-201(5)(a), in the State of Tennessee and elsewhere, where authorized.

The Company's Charter states the Board of Directors shall have the power to fill any vacancies to the Board until the next annual meeting of the stockholders. The Charter also gives the Board of Directors the power to elect all officers, to discharge officers, with or without cause and such other powers as may be prescribed from time to time in the Corporation's Bylaws.

In addition to the above, the Company's Charter recites other general and specific powers in detail. They are usual in nature and consistent with statute.

Bylaws:

The Company's Bylaws were most recently amended on September 18, 2003. The Bylaws provide for an annual shareholders' meeting at which a Board of Directors is elected. Officers are elected by the Board annually at the first Board meeting after the annual shareholders meeting.

The current Bylaws are such as generally found in corporations of this type and contain no unusual provisions. They provide for the regulation of the business and for the conduct of the affairs of the Company.

MANAGEMENT AND CONTROL

Management of the Company is vested in a Board of Directors which is elected annually by the shareholder. The Board of Directors must consist of no less than two (2) nor more than twelve (12) members, with the exact number to be fixed by the Board of Directors from time to time. Directors serve until the next annual meeting of the shareholders and thereafter, until a successor has been elected.

The following persons were serving as members of the Board of Directors at December 31, 2005:

<u>Name</u>	<u>Principal Occupation</u>
Jacqueline C. Adair	Chairman of the Board and Chief Executive Officer
Tammy R. Adair	Executive Vice President
John Todd Hagely	Senior Vice President and Chief Financial Officer

The Bylaws state that the Board of Directors will elect officers of the Company which must include a Chairman of the Board, a Chief Executive Officer, a President and a Secretary. The corporation may also have one or more Vice-Presidents, one or more assistant Secretaries, one or more assistant Treasurers, and such other officers as the Board of Directors shall from time to time deem necessary. Any two or more offices may be held by the same person, except the offices of President and Secretary. Also, the Board of Directors shall designate either the Chairman of the Board or the President to be the Chief Executive Officer of the corporation.

The following officers were duly elected and were serving at December 31, 2005:

<u>Name</u>	<u>Title</u>
Jacqueline C. Adair	President and Chief Executive Officer
Matthew P. McClure	Corporate Secretary
John T. Hagely	Senior Vice President and Chief Financial Officer
Tammy R. Adair	Executive Vice President
Steven R. Harms	Vice President - Finance & Treasurer
Scott A. Johnson	Vice President - Claims
Ronald F. Wilson	Assistant Secretary
Constance A. Collins	Assistant Secretary
Jill A. Fritts	Assistant Secretary
Lewis J. Walker	Assistant Secretary

The Bylaws also allow the Directors to create one or more committees which may consist of a single member. The Bylaws also state that all committees so created shall have such powers as the Board of Directors may delegate to such committee.

At December 31, 2005, the Company had an Investment Committee which consisted of J. Todd Hagely, along with the following members, who serve ex officio:

William Adair	William Harter
Kim Jones	Brian Moore

Investment transactions for the period under review were approved by the Board of Directors from quarterly reports of aggregate investment transactions.

The Company has no employees of its own. Personnel and services are provided by the Company's parent, DGC, and affiliates, primarily Direct Administration, Inc. and Direct Adjusting Company, Inc., in accordance with an Intercompany Cost Allocation Agreement.

Pecuniary Interest:

The Company's parent, DGC, has a written "Policy on Business Conduct." According to this policy, directors, officers and certain employees are required to complete a Policy on Business Conduct Annual Questionnaire. This questionnaire is used for all entities within the holding company system and persons required to complete the certificate sign only one form regardless of the number of positions they hold with different companies throughout the system. According to the policy, potential conflicts of interests, as discovered by or reported to the president of DGC, are submitted to a committee of senior officers as designated by the chairman of the board. Any recommended resolution of potential conflicts must be approved by DGC's board of directors.

The questionnaires completed by management during the period under examination were reviewed and no exceptions were noted.

Control:

At December 31, 2005, one hundred percent (100%) of the outstanding shares of the Company were owned by DGC. During the examination period, dividends were paid to DGC as follows:

Year	Amount
2002	\$1,250,000
2003	1,000,000
2004	1,000,000
2005	500,000

CORPORATE RECORDS

The minutes of the meetings of the Shareholders, Board of Directors, and Investment Committee were reviewed for the period under examination. They were found to be complete as to necessary detail and appear to properly reflect the actions of the respective bodies.

HOLDING COMPANY SYSTEM

The Company and its parent, DGC, are members of an insurance holding company system, as defined by Tenn. Code Ann. § 56-11-201, of which DGC is the ultimate parent. An organizational chart is attached to this report as Attachment A.

AGREEMENTS WITH PARENT, SUBSIDIARIES AND AFFILIATES

The Company had three (3) agreements with affiliated companies in effect as of December 31, 2005. The following are summaries of the agreements in effect as of this examination for the Company:

Intercompany Cost Allocation Agreement:

Effective April 29, 1997, the Company entered into an Intercompany Cost Allocation Agreement (Agreement) with its parent, DGC, and affiliated companies whereby the entities share the costs of certain administrative, personnel, legal, accounting, tax, information systems, strategic planning, and other shared services. Essentially, DGC, Direct Administration, Inc. (DAI) and Direct Adjusting Company, Inc. (DACI), provide these services to the Company and its affiliated insurers. The "other shared services" provided include appraisal, claims adjusting, claims payment and other claims-related services.

As payment for these services, DGC, DAI and DACI may "charge reasonable fees at arm's length rates based upon the allocation of the costs incurred in providing services pursuant to this Agreement." Written itemized invoices are submitted to the Company "periodically, but no less frequently than at the end of each calendar quarter" for payment.

Nothing in the Agreement is intended to modify the terms of the Account Settlement Agreement between the Company and DGFS, discussed below.

Account Settlement Agreement:

On December 1, 1994, the Department approved an Account Settlement Agreement between the Company and its affiliate Direct General Financial Services, Inc. (DGFS), which finances premiums for the Company's insureds. Under this agreement, DGFS's obligations to the Company are "in the nature of an account current settlement on an agency account" consisting of premiums that DGFS is obligated to remit to the Company. The Company's obligation to DGFS consists of refund premiums arising out of cancellations of insurance policies financed by DGFS for the Company's insureds.

The agreement states that these obligations shall be offset against each other and the balance (the Net Settlement Amount) settled not less frequently than once a month. Also, "the maximum Net Settlement Amount to which this Agreement shall apply shall be \$6 million during the course of any month" and no amounts due from the Company to DGFS "shall become due and payable until and unless the approval of the Commissioner of Commerce and Insurance shall have been sought and secured."

On June 30, 2006, the Company submitted to the Department for approval a Premium Finance Settlement Agreement which replaces the Account Settlement Agreement. This agreement was approved effective as of August 28, 2006.

Tax Allocation Agreement:

Effective September 10, 1996, the Company became a party to a tax allocation agreement by and among DGC and its subsidiaries. The agreement applies to the taxable year ending December 31, 1995 and all subsequent periods. Under this agreement, DGC shall file a U.S. consolidated income tax return on behalf of the

members of the holding company system. Payments shall be made to DGC by the subsidiaries within ten days of receiving notice of such payment from DGC and DGC shall return excess payments to the subsidiaries within ten days after the date of filing of the consolidated return for such period.

A supplement to this agreement was made effective on November 9, 2000. Its purpose was to add new subsidiaries to the affiliated group as defined in Internal Revenue Code Section 1504(a), and to provide for the addition of subsidiaries in the future.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured under certain insurance coverages being carried by its parent, DGC. The following is a summary of the various bonds and insurance policies that provided the enumerated coverages to the Company at December 31, 2005:

Type of Coverage	Limits of Liability
1. Fidelity bond, comprehensive crime, Form 25	\$ 5,000,000 single loss limit \$ 100,000 single loss deductible
2. Commercial general liability	\$ 2,000,000 general aggregate \$ 1,000,000 each occurrence \$ 1,000,000 personal & advertising injury \$ 10,000 medical expense
3. Employee benefits liability	\$ 1,000,000 each occurrence \$ 1,000,000 aggregate
4. Employment practices liability	\$ 5,000,000 each claim \$ 5,000,000 aggregate \$ 500,000 deductible
5. Business automobile Uninsured motorists	\$ 1,000,000 each accident \$ 1,000,000 each accident \$ 5,000 medical payments
6. Professional liability	\$30,000,000 aggregate \$ 1,000,000 deductible each claim
7. Directors and officers liability	\$30,000,000 aggregate for policy period
8. Workers compensation liability	
A. Workers compensation	Tennessee statutory limit
B. Employers liability	
a. Bodily injury by accident	\$ 500,000 each accident
b. Bodily injury by disease	\$ 500,000 policy limit
c. Bodily injury by disease	\$ 500,000 each employee

Minimum fidelity coverage suggested in the National Association of Insurance Commissioners' Examiners Handbook for an insurer of the Company's size and premium volume is not less than \$700,000, which the Company exceeds. The bonds and policies affording the aforementioned coverages were inspected and appear to be in-force as of the date of this examination. All of the above insurance policies were written by companies that were either licensed insurers or approved surplus lines carriers in Tennessee.

EMPLOYEE BENEFITS AND PENSION PLANS

Full-time employees of entities in the holding company system are eligible to participate in the DGC benefit plans. The following is a summary of the programs available to employees as of December 31, 2005:

Group Health Coverage (PPO);	Offered through a Preferred Provider Organization Company contributes 88% of employee premium; employee contributes 100% of dependent coverage.
Group Dental Coverage	Offered through Delta Dental of Tennessee; employee contributes 100% of premium.
Term Life and AD&D Insurance	Company contributes 100% of premium; coverage is one times annual base salary with a minimum of \$15,000.
Additional Life and STD 401(k) Plan	Optional; employee contributes 100% of premium. Employees may contribute up to 15% of pretax income; Company will match 60% of employee contributions up to 5% of eligible compensation. The match is fully vested after the sixth year of service.

TERRITORY AND PLAN OF OPERATION

Territory

The Company is licensed to transact the business of property and casualty insurance in the State of Tennessee and property, casualty (excluding workers' compensation) and marine insurance in the State of Arkansas. The Company is an accredited reinsurer in the State of Texas. Certificates of Authority for each jurisdiction were reviewed and found to be valid.

The following table shows the premiums by state for the year ending December 31, 2005 as reported in Schedule T of the Company's Annual Statement:

State	Direct Premiums Written	Direct Premiums Earned	Direct Losses Paid	Direct Losses Incurred	Direct Losses Unpaid
Arkansas	13,006,377	13,181,352	7,689,649	8,613,628	5,595,138
<u>Tennessee</u>	<u>55,064,348</u>	<u>57,718,666</u>	<u>35,452,178</u>	<u>35,470,021</u>	<u>21,448,261</u>
<u>Total</u>	<u>\$68,070,725</u>	<u>\$70,900,018</u>	<u>\$43,141,827</u>	<u>\$44,083,649</u>	<u>\$27,043,399</u>

Plan of Operation

The Company writes non-standard private passenger automobile insurance in Tennessee and Arkansas. Affiliated insurance agencies sell the Company's products directly through neighborhood sales offices. Approximately 95% of the policies sold are financed by the affiliated premium finance company. The affiliated agencies are paid

commissions in accordance with agency agreements. The agencies appoint agents via the State of Tennessee's Notification of Agency Contract or Agreement.

MARKET CONDUCT ACTIVITIES

Underwriting:

The Company writes non-standard automobile insurance that generally provides basic limits coverage as follows:

Bodily Injury: \$25,000 per person/\$50,000 per occurrence
Property Damage: \$10,000 per occurrence

Increased limits (\$50,000/\$100,000/\$25,000 and \$100,000/\$300,000/\$50,000) as well as uninsured/underinsured motorists coverages are available, as are various endorsements, such as for custom and special equipment, towing, rental car coverage and accident death benefits. Discounts are given for renewals, prior insurance, multi-car policies, homeownership and accident prevention courses.

Rates and Policy Forms:

The current rates and policy forms were duly filed with and approved by the Tennessee Department of Commerce and Insurance.

Complaints:

The Company maintains a log for complaints which have been received from the various insurance departments, insureds and complainants, and other interested third parties such as the Better Business Bureau or attorneys. For each complaint, the log documents the date the complaint was initially received, reference number, policy number, claim number (if applicable), name of insured, complainant (who might or might not be an insured), reason for complaint and a summary of the resolution.

The examiner reviewed the complaints for the period under examination and summarized them by type as follows:

<u>Complaint Concerning:</u>	<u>Number of Complaints</u>	<u>Percent</u>
Claims adjusting and settling, claims payments, and quality of work performed on vehicles	186	81.2
Refunds (premium finance)	15	6.6
Policy cancellation (by Company and insureds)	12	5.2
Underwriting, coverage in effect	6	2.6
Miscellaneous	10	4.4
Total	229	100.0%

Complaint documentation in the log is complete enough to determine the general nature of the complaint. More specific documentation is maintained in the policy and claims files.

Claims:

A sample of claims reviewed during the examination indicated that claims were being paid in accordance with policy provisions and settlements were promptly made upon receipt of proper evidence of the Company's liability.

Advertising:

The Company has an extensive advertising program that includes television and radio commercials. Written copy, as well as the actual commercials were reviewed by the examiners; no material exceptions were noted.

LOSS EXPERIENCE

As developed from applicable amounts included in the Company's annual statements filed with the Department of Commerce and Insurance for the State of Tennessee, the ratios of losses and loss adjustment expenses (LAE) incurred to earned premiums for the period subject to this examination were as follows:

<u>Year</u>	<u>Losses & LAE Incurred</u>	<u>Earned Premiums</u>	<u>Loss Ratio</u>
2002	26,576,567	37,621,679	70.6%
2003	35,359,148	47,247,671	74.8%
2004	45,563,999	60,861,885	74.9%
2005	49,382,176	67,678,198	73.0%
Total	\$156,881,890	\$213,409,433	73.5%

REINSURANCE AGREEMENTS

Reinsurance Assumed:

The Company assumes private passenger auto business written by its agency system under a quota share agreement with Mutual Casualty Service Insurance Company (MCSIC). 100% of the assumed business is retained by the Company. In 2002, the Company ceased assuming business from MSCIC, however this treaty is still in run-off.

Reinsurance Ceded:

The primary intent of the Company's reinsurance agreements is to manage the Company's overall exposure to loss at or below a level that is within the capacity of its capital resources.

The Company carries property catastrophe excess of loss reinsurance with retention of \$2 million and a limit of \$15 million. The treaty, effective January 1, 2005 through January 1, 2006, covers in force, new, renewal, and assumed private passenger automobile physical damage business with the maximum value per vehicle covered of \$75,000. The major reinsurers and their participation are summarized below:

Reinsurers/Participation:

	1 st	Layer 2 nd	3 rd
Endurance Specialty Insurance Ltd.	20.0%	20.0%	20.0%
IPCRE Ltd.	15.0%	15.0%	15.0%
QBE Ltd.	25.0%	15.0%	15.0%
XL Re Ltd.	12.5%	12.5%	12.5%

The remaining reinsurers are Brit Insurance Ltd., Aspen Insurance UK Ltd., and various Lloyd's syndicates. The reinsurance agreements were found to contain acceptable clauses for insolvency and arbitration. The Company's reinsurance agreements appear to effectuate proper transfer of risk in accordance with SSAP No. 62 and NAIC guidelines.

LITIGATION AND CONTINGENT LIABILITIES

From the data made available during the progress of this examination, it would appear that most of the cases of law in which the Company was involved, during the period under review, were those relating to the settlement of claims.

One exception to the statement above is a lawsuit filed against DGC, the Company's parent. In 2005, DGC and certain of its officers and directors were named as defendants in six class action lawsuits filed in the United States District Court. These cases have been consolidated and lead plaintiffs have been appointed. The lead plaintiffs allege that DGC and certain of its officers and directors made false and misleading statements with respect to liabilities that had been recorded for unpaid losses and loss adjustment expenses. The lead plaintiffs contend that DGC and its officers and directors knew that legislation in Florida, which became effective in October 2003, would negatively impact the DGC's business by increasing its liability and risk of litigation and that DGC failed to timely strengthen its loss reserves to account for this future risk. Lead plaintiffs also allege that certain officers and directors sold shares of DGC stock while they were aware of the future negative impact of the legislation, but before the reserves were strengthened. The lead plaintiffs seek to recover damages on behalf of all purchasers of DGC stock during a class period to be determined and attorneys' fees. See the Subsequent Events section of this report for additional information on the resolution of this lawsuit.

The Company does not have any contingent liabilities as of December 31, 2005 as a result of this litigation. This litigation appears to be covered by an officers and directors liability policy.

The Company also apparently had no other agreements or pending matters of a contingent nature that would materially affect its financial position or operating results at December 31, 2005.

STATUTORY DEPOSITS

In compliance with statutory and other requirements, the Company maintained the following deposits with the named jurisdictions or custodians as of December 31, 2005:

Deposits Which Are Not for the Benefit of all Policyholders:

Jurisdiction	Description of Security	Par Value	Statement Value	Market Value
Arkansas – Dept. of Insurance	Shelby County, TN 5.25%, Due 04-01-10 Cusip # 821686-JV-5	\$400,000	\$412,574	\$427,984
Total deposits which are not for the benefit of all policyholders:		<u>\$400,000</u>	<u>\$412,574</u>	<u>\$427,984</u>

Deposits Which are for the Benefit of All Policyholders:

Jurisdiction	Description of Security	Par Value	Statement Value	Market Value
Tennessee – Dept. of Insurance	Tennessee State GO Bond 4.80%, Due 05-01-06 Cusip # 880540-M2-2	\$ 255,000	\$ 255,052	\$ 256,221
Tennessee – Dept. of Insurance	Shelby County, TN Bond 5.0%, Due 03-01-10 Cusip # 821686-RG-9	500,000	547,611	530,355
Tennessee – Dept. of Insurance	Metro Govt. Nashville/Davidson Co. 5.25%, Due 10-15-09 Cusip # 592013-5T-9	555,000	592,958	590,675
Tennessee – Dept. of Insurance	Metro Govt. Nashville/Davidson Co. 5.0%, Due 05-15-11 Cusip # 592030-VB-3	235,000	257,810	251,812
Total deposits which are for the benefit of all policyholders:		<u>\$1,545,000</u>	<u>\$1,653,431</u>	<u>\$1,629,063</u>
Total Deposits		<u>\$1,945,768</u>	<u>\$2,066,005</u>	<u>\$2,057,047</u>

Deposits with said jurisdictions or custodians were verified by direct correspondence with the custodian of such deposit, with no exceptions noted.

ACCOUNTS AND RECORDS

During the course of examination, such tests and audit procedures were made as were considered necessary, including verification of postings, extensions and footings. General ledger trial balances were reconciled with the Annual Statements for the years 2002, 2003, 2004 and 2005.

Accounting records conform to generally accepted insurance accounting practices and appear to properly reflect the operations during the period under examination and the status of the Company at the date of examination.

Intercompany balances, including management fees, federal income taxes, premiums, losses and loss adjustment expenses are settled between the Company and its affiliates on a monthly basis.

The Company is audited annually as part of the audit conducted for the holding company system, of which it is a member, by an independent accounting firm. The audit was performed by Ernst & Young, LLP for the year ending December 31, 2005. The auditors' workpapers for the year ended 2005 were made available to the examiners during the planning phase of this examination. Workpapers of the auditors' substantive testing and their documentation of the Company's procedures and verification of internal controls were relied upon where sufficient for the purposes of this examination. Copies of these workpapers are included in the examination files where appropriate.

The Company's Risk-Based Capital Report was reviewed and found to be in compliance with Tenn. Code Ann. § 56-46-101, *et seq.*

LOSS RESERVES

An independent actuarial analysis of the Company's loss reserves was performed by AGI Services in conjunction with this examination. Their analyses were performed on direct and assumed data due to the multiple changes in the Company's reinsurance program over the years. Based upon the gross reserve analyses, a review of the Company's analyses and a review of the Company's ceded reserves, AGI concluded that the Company's carried net loss and loss adjustment expense reserves are reasonable.

SUBSEQUENT EVENTS

Holding Company System:

On December 5, 2006, DGC announced its execution of a definitive Agreement and Plan of Merger with Elara Holdings, Inc. and Elara Merger Corporation, pursuant to which Elara Holdings, Inc. would acquire 100% of the issued and outstanding common stock of DGC (the "Transaction"). Elara Holdings, Inc. is an affiliate of Calera Capital (formerly known as Fremont Partners) and TPG Capital (formerly known as Texas Pacific Group). In connection with the Transaction, DGC's shareholders would receive \$21.25 in cash for each share of DGC common stock that they held. In connection with the Transaction, DGC filed a proxy statement with the Securities and Exchange Commission on February 5, 2007 and DGC's shareholders approved the Transaction on March 8, 2007. The Transaction was also subject to receipt of regulatory approvals and satisfaction of closing conditions.

A Form A hearing was held with the Department and its approval was granted pursuant to a final Order dated March 22, 2007. After receipt of other approvals and satisfaction

of closing conditions, the Transaction closed on March 30, 2007.

Litigation and Contingent Liabilities:

On March 2, 2007, DGC entered into a Memorandum of Understanding with other defendants and the plaintiffs to settle the pending securities class action lawsuit. (This is described in the Litigation and Contingent Liabilities section of this report.) The stipulated settlement amount is \$14.94 million, and the plaintiffs agree to dismiss with prejudice all claims against all defendants to the action. DGC, its directors, and current and former officers do not admit to liability or fault.

The Memorandum of Understanding was subject to several conditions, including approval by the court, which approval was granted by Order dated May 8, 2007. In accordance with the settlement agreement, on May 21, 2007, DGC funded its portion of the settlement escrow fund in the amount of \$3.24 million. The final Settlement Hearing is scheduled for July 20, 2007.

FINANCIAL STATEMENT

There follows a statement of assets, liabilities and statement of income at December 31, 2005, together with a reconciliation of capital and surplus for the period under review, as established by this examination:

ASSETS

	Ledger Assets	Nonadmitted Assets	Net Admitted Assets
Bonds	\$70,366,981	0	\$70,366,981
Real estate occupied by the company	644,099	0	644,099
Cash and short-term investments	9,075,878	0	9,075,878
Receivables for securities	<u>150,749</u>	<u>0</u>	<u>150,749</u>
Subtotals, cash and invested assets	80,237,707	0	80,237,707
Investment income due and accrued	724,040	0	724,040
Uncollected premiums and agents' balances in the course of collection	4,387,533	0	4,387,533
Amounts recoverable from reinsurers	576,387	0	576,387
Funds held by or deposited with reinsured companies	250,000	0	250,000
Current federal and foreign income tax recoverable and interest thereon	187,844	0	187,844
Net deferred tax asset	2,868,000	420,798	2,447,202
Guaranty funds receivable or on deposit	97,448	0	97,448
Receivables from parent, subsidiaries and affiliates	66,835	0	66,835
Aggregate write-ins for other than invested assets	<u>318</u>	<u>0</u>	<u>318</u>
Totals	<u>\$89,396,112</u>	<u>\$420,798</u>	<u>\$88,975,314</u>

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses		\$25,085,856
Reinsurance payable on paid losses and loss adjustment expenses		10,224
Loss adjustment expenses		1,431,082
Commissions payable; contingent commissions and other similar charges		498,517
Other expenses (excluding taxes, licenses and fees)		183,737
Taxes, licenses and fees (excluding federal and foreign income taxes)		179,710
Unearned premiums		33,397,973
Ceded reinsurance premiums payable (net of ceding commissions)		117,919
Funds held by company under reinsurance treaties		161,613
Amounts withheld or retained by company for account of others		15,617
Remittances and items not allocated		13,615
Payable to parent; subsidiaries and affiliates		604,234
Payable for securities		355,862
Aggregate write-ins for liabilities		<u>120</u>
Total liabilities		\$62,056,079
Common capital stock	2,519,175	
Gross paid in and contributed surplus	11,823,125	
Unassigned funds (surplus)	<u>12,576,935</u>	
Surplus as regards policyholders		\$26,919,235
Totals		<u>\$88,975,314</u>

STATEMENT OF INCOME

UNDERWRITING INCOME

Premiums earned		\$ 67,678,198
Deductions		
Losses incurred	42,411,728	
Loss expenses incurred	6,970,448	
Other underwriting expenses incurred	<u>14,959,484</u>	
Total underwriting deductions		<u>\$ 64,341,660</u>
Net underwriting gain		\$ 3,336,538

INVESTMENT INCOME

Net investment income earned	2,542,315	
Net realized capital gains or (losses)	<u>(129,737)</u>	
Net investment gain or (loss)		\$ 2,412,578

OTHER INCOME

Aggregate write-ins for miscellaneous income	<u>209,334</u>	
Total other income		\$ 209,334
Net income before federal and foreign income taxes		5,958,450
Federal and foreign income taxes incurred		<u>1,989,540</u>
Net income		<u>\$ 3,968,910</u>

CAPITAL AND SURPLUS ACCOUNT

GAINS AND LOSSES IN SURPLUS

Surplus as regards policyholders, December 31 previous year		\$23,103,434
Net income	3,968,910	
Change in net deferred income tax	108,293	
Change in non-admitted assets	238,598	
Dividends to stockholders	<u>(500,000)</u>	
Net change in surplus for the year		<u>3,815,801</u>
Surplus as regards policyholders, December 31 current year		<u>\$26,919,235</u>

RECONCILIATION OF CAPITAL AND SURPLUS
FOR THE PERIOD UNDER EXAMINATION

	2002	2003	2004	2005
Surplus as regards policyholders, December 31, previous year	\$12,874,904	\$17,560,229	\$20,531,788	\$23,103,434
Net income	4,962,627	1,427,917	3,004,869	3,968,910
Net unrealized capital gains or (losses)	769,622	667,847	-	-
Change in net deferred income tax	614,130	691,097	319,891	108,293
Change in non-admitted assets	(261,302)	(311,988)	(86,106)	238,598
Dividends to stockholders	(1,250,000)	(1,000,000)	(1,000,000)	(500,000)
Aggregate write-ins for gains and losses in surplus	(149,752)	1,496,686	332,992	-
Net change for the year	<u>4,685,325</u>	<u>2,971,559</u>	<u>2,571,646</u>	<u>3,815,801</u>
Surplus as regards policyholders, December 31, current year	<u>\$17,560,229</u>	<u>\$20,531,788</u>	<u>\$23,103,434</u>	<u>\$26,919,235</u>

**ANALYSIS OF CHANGES IN FINANCIAL STATEMENT
AND COMMENTS RESULTING FROM EXAMINATION**

Differences in various items were noted during the course of examination; however, none were considered to produce a material effect on surplus funds as regards policyholders, either singly or in the aggregate.

**ANALYSIS OF CHANGES IN FINANCIAL STATEMENT
AS THEY AFFECT SURPLUS**

No schedule or comment is applicable. All noted differences were below the materiality threshold established for examination purposes.

COMMENTS AND RECOMMENDATIONS

Comments:

1. Bonds

As of December 31, 2005, the Company held securities in two custodial accounts at U.S. Bank. One account was set up as a primary, with account number 19-1652, while the second was a sub-account with account number 19-1652A. While the first account had the Company's complete correct name, the sub-account did not have the correct name listed. The Company corrected this error during the course of the examination.

It is recommended that the Company exercise diligence in setting up its custodial accounts and continue to comply with Tenn. Comp. R. & Regs. 0780-1-46 and guidelines set in the *NAIC Financial Condition Examiners Handbook* concerning custodian agreements with banks where they hold securities at all times.

2. Information Systems

It was noted during the review of the Company's Information Systems that the sales offices which produce the Company's business each have multiple desktop computers which do not have any virus protection. These computers connect to the systems at DGC to upload transactions and images. This could expose the corporate systems to infection.

It is suggested that the Company obtain virus protection software for all of its computers that connect to the Company's Information Systems.

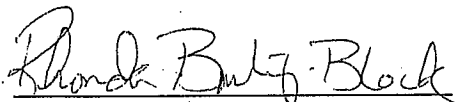
CONCLUSION

The customary insurance examination practices and procedures, as established by the NAIC, have been utilized in connection with the verification and valuation of assets and the determination of liabilities in the financial statement of this report.

In such manner, it was determined that as of December 31, 2005, the Company had net admitted assets of \$88,975,314 and liabilities, exclusive of capital, of \$62,056,079. Thus, there existed for the additional protection of the policyholders, the amount of \$26,919,235 in the form of paid-up capital, gross paid-in and contributed surplus and unassigned funds (surplus).

In addition to the undersigned, Sandy M. Banks and Stephanie M. Brooks, Insurance Examiners for the State of Tennessee, Norman Chandler, CPA, CPCU, AIA, AIAF, ARC, of TaylorChander, LLC, and Jenny L. Jeffers, CISA, AES and Doug Moulton, ACAS, MAAA, of AGI Services, participated in this examination.

Respectfully submitted,



Rhonda Bowling-Black, CFE
Examiner-in-Charge
State of Tennessee
Southeastern Zone, NAIC

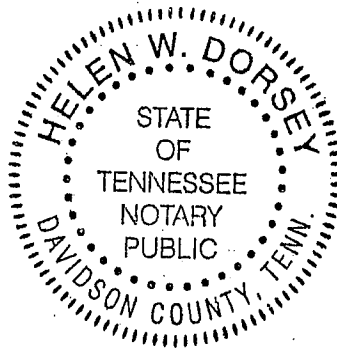
AFFIDAVIT

The undersigned deposes and says that she has duly executed the attached examination report of Direct Insurance Company dated June 8, 2007, and made as of December 31, 2005, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says she is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of her knowledge, information and belief.

Rhonda Bowling Black
Rhonda Bowling-Black, CFE
Insurance Examiner
State of Tennessee
Southeastern Zone, NAIC

Subscribed and sworn to before me this
8th day of June, 2007

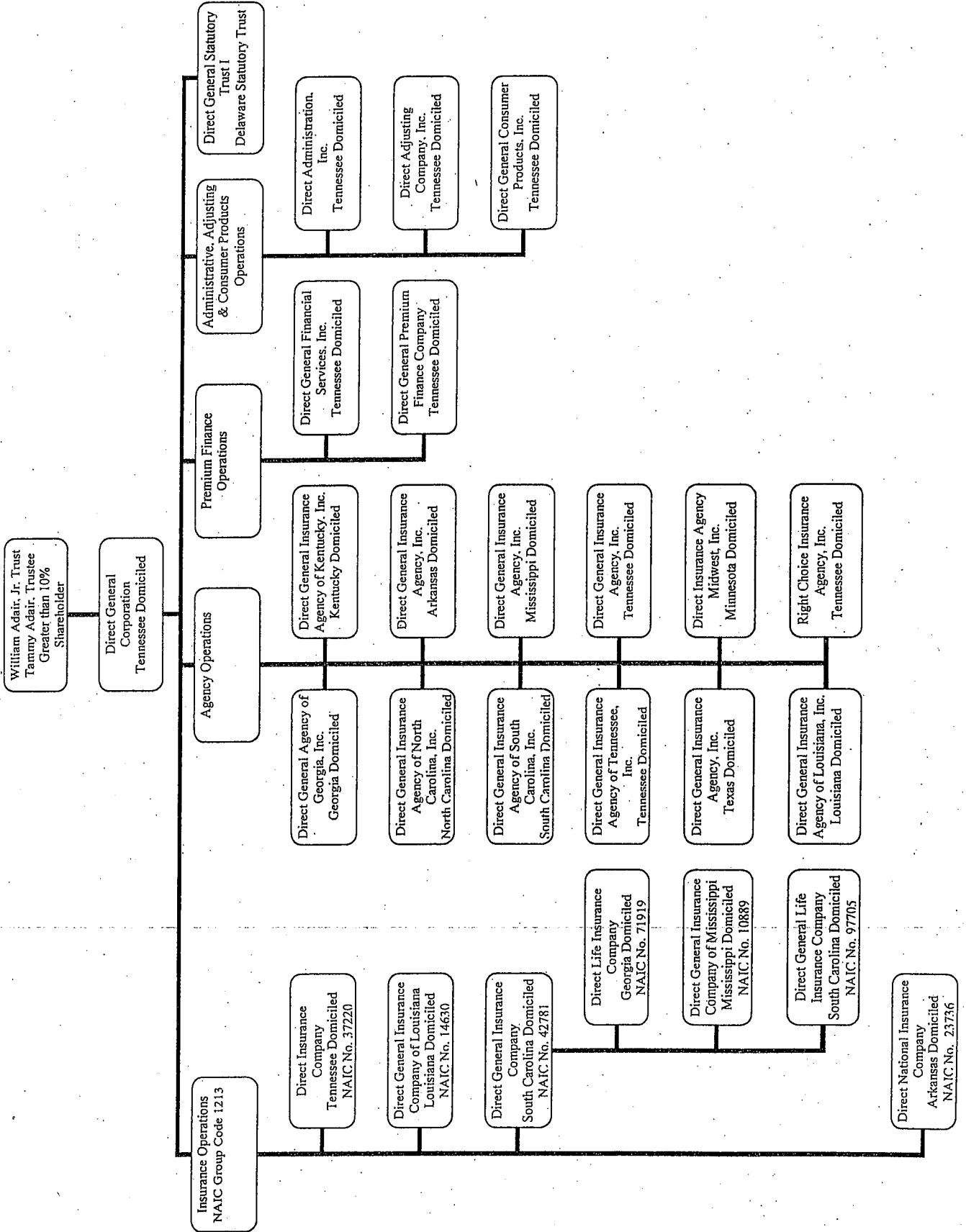
Notary Helen W. Dorsey
County Davidson
State Tennessee



Commission Expires 05/22/2010

My Commission Expires MAY 22, 2010

ORGANIZATIONAL CHART



DIRECT INSURANCE COMPANY

1281 MURFREESBORO ROAD
NASHVILLE, TENNESSEE • 37217

June 21, 2007

RECEIVED

JUN 22 2007

State of Tennessee
Department of Commerce and Insurance
Attn: Philip Blustein, CFE
500 James Robertson Parkway
Nashville, TN 37243

Financial Affairs
Analytical Unit

Re: Financial Examination of Direct Insurance Company
Comments and Recommendations

Dear Mr. Blustein:

The Tennessee Department of Commerce and Insurance (the "Department") recently completed an examination as to the financial condition of Direct Insurance Company (the "Company") as of December 31, 2005 and submitted its Report on Examination of the Company on June 8, 2007. The purpose of this letter is to summarize the Department's comments and recommendations and to document the Company's responses thereto.

1. Bonds.

Recommendation, Page 22: It is recommended that the Company exercise diligence in setting up its custodial accounts and continue to comply with Tenn. Comp. R. & Regs. 0780-1-46 and guidelines set in the *NAIC Financial Condition Examiners Handbook* concerning custodian agreements with banks where they hold securities at this time.

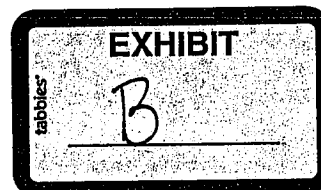
Response: The Company will exercise diligence in establishing its custodial accounts and will continue to comply with Tenn. Comp. R & Regs. 0780-1-46 and the guidelines set forth in the *NAIC Financial Condition Examiners Handbook* concerning custodian agreements with banks where the Company maintains securities.

2. Information Systems.

Recommendation, Page 22: It is suggested that the Company obtain virus protection software for all of its computers that connect to the Company's Information Systems.

Response: The sales offices run a closed system without the ability to load any program or data except as a part of an application distributed from the Nashville home office. There is no permanent data residing at the sales office; it is simply a daily entry and balancing point for customer sales and payment collection.

The corporate systems are not vulnerable to a virus being found in the sales office. Virus protection, closed systems and firewalls protect the corporate environment. In the last seven years, there have been no viruses transported from the sales office to the corporate environment. Management's conclusion is that this is an unnecessary expense and is not cost justified.



Mr. Philip Blustein, CFE
June 21, 2007
Page 2

The above responses are respectfully submitted to address the Department's recommendation and suggestion contained in the Examination Report of Direct Insurance Company as of December 31, 2005. It is the Company's understanding that a copy of this document will be included as part of the Examination Report package to be filed with regulatory authorities and other interested parties.

If you have any questions or need additional information, please contact me directly at 1-800-330-4541 x 3723.

Sincerely,

DIRECT INSURANCE COMPANY

By: Stephane D. Johnson
For Constance A. Collins
Senior Counsel & Assistant Secretary

cc: Dan Tarantin
Chief Executive Officer

Tammy R. Adair
President

J. Todd Hagely
Executive Vice President & CFO