

21ST CENTURY HOLDING CO  
Form 10-Q  
August 11, 2006

**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**  
**FORM 10-Q**

**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**

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

Commission file number 0-2500111

21<sup>st</sup> Century Holding Company  
(Exact name of registrant as specified in its charter)

Florida  
(State or Other Jurisdiction of  
Incorporation or Organization)

65-0248866  
(IRS Employer  
Identification No.)

3661 West Oakland Park Boulevard, Suite 300, Lauderdale Lakes, Florida 33311  
(Address of principal executive offices) (Zip Code)

954-581-9993  
(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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes  No

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

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Common Stock, \$.01 par value - 7,692,074 outstanding as of August 11, 2006

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**21<sup>ST</sup> CENTURY HOLDING COMPANY**

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**PART I: FINANCIAL INFORMATION****Item 1**21<sup>ST</sup> CENTURY HOLDING COMPANY  
CONSOLIDATED BALANCE SHEETS

| ASSETS   | June 30, 2006         | December 31, 2005     |
|--|-----------------------|-----------------------|
| Investments  |                       |                       |
| Fixed maturities, available for sale, at fair value  | \$ 99,377,423         | \$ 69,787,809         |
| Fixed maturities, held to maturity, at amortized cost  | 19,679,749            | 19,691,937            |
| Equity securities, available for sale, at fair value   | 14,699,165            | 10,606,663            |
| <b>Total investments</b>   | <b>133,756,337</b>    | <b>100,086,409</b>    |
| Cash and cash equivalents  | 9,958,979             | 6,071,460             |
| Receivable for investments sold  | 17,022,140            |                       |
| Finance contracts, net of allowance for credit losses of \$221,066 in 2006 and \$419,445 in 2005, and net of unearned finance charges of \$170,594 in 2006 and \$379,212 in 2005 | 3,723,486             | 7,312,736             |
| Prepaid reinsurance premiums   | 2,869,073             | 12,133,734            |
| Premiums receivable, net of allowance for credit losses of \$192,596 and \$158,151, respectively   | 10,231,312            | 7,505,631             |
| Reinsurance recoverable, net   | 16,167,555            | 136,675,703           |
| Deferred policy acquisition costs  | 11,944,450            | 9,183,654             |
| Deferred income taxes, net   | 4,995,491             | 2,703,978             |
| Property, plant and equipment, net   | 1,421,273             | 3,901,385             |
| Other assets   | 5,371,150             | 4,580,063             |
| <b>Total assets</b>  | <b>\$ 217,461,246</b> | <b>\$ 290,154,753</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                       |
| Unpaid losses and LAE  | \$ 31,344,127         | \$ 154,038,543        |
| Unearned premiums  | 85,016,274            | 61,839,051            |
| Premiums deposits  | 3,402,861             | 2,144,863             |
| Revolving credit outstanding   | -                     | 196,943               |
| Bank overdraft   | 10,291,955            | 12,237,735            |
| Funds held under reinsurance treaties  | 1,568,871             | 1,544,544             |
| Income taxes payable   | 7,718,037             | 3,019,696             |
| Subordinated debt  | 6,875,000             | 10,208,333            |
| Deferred gain from sale of property  | 2,680,940             | -                     |
| Accounts payable and accrued expenses  | 5,644,948             | 4,157,675             |
| <b>Total liabilities</b>   | <b>154,543,013</b>    | <b>249,387,383</b>    |
| Shareholders' equity:  |                       |                       |
| Common stock, \$0.01 par value. Authorized 37,500,000 shares; issued 8,102,298 and   | 81,022                | 74,688                |

7,468,713 shares, respectively; Outstanding 7,405,449 and 6,771,864, respectively

|  |                |                |
|--|----------------|----------------|
| Additional paid-in capital                 | 40,517,377     | 31,825,053     |
| Accumulated other comprehensive (deficit)  | (1,757,766)    | (1,537,243)    |
| Retained earnings                          | 24,077,600     | 10,404,872     |
| Total shareholders' equity                 | 62,918,233     | 40,767,370     |
| Total liabilities and shareholders' equity | \$ 217,461,246 | \$ 290,154,753 |

**SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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21<sup>ST</sup> CENTURY HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|   | Three Months Ended |               | Six Months Ended |               |
|---|--------------------|---------------|------------------|---------------|
|   | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Revenue:  |                    |               |                  |               |
| Gross premiums written  | \$ 50,752,672      | \$ 31,362,908 | \$ 86,361,745    | \$ 61,459,952 |
| Gross premiums ceded  | (3,371,781)        | (2,053,152)   | (3,371,781)      | (4,954,443)   |
| Net premiums written  | 47,380,891         | 29,309,756    | 82,989,964       | 56,505,509    |
| Decrease in prepaid reinsurance premiums                                  | (593,089)          | (2,835,083)   | (9,264,661)      | (5,510,378)   |
| (Increase) in unearned premiums   | (18,047,162)       | (4,585,523)   | (23,177,223)     | (10,271,083)  |
| Net change in prepaid reinsurance premiums and unearned premiums          | (18,640,251)       | (7,420,606)   | (32,441,884)     | (15,781,461)  |
| Net premiums earned   | 28,740,640         | 21,889,150    | 50,548,080       | 40,724,048    |
| Finance revenue   | 496,117            | 937,681       | 1,132,143        | 2,042,211     |
| Managing general agent fees   | 723,020            | 620,378       | 1,380,988        | 1,252,693     |
| Net investment income   | 1,612,014          | 910,925       | 2,808,279        | 1,803,796     |
| Net realized investment gains   | 283,341            | 125,510       | 479,552          | 285,033       |
| Other income  | 486,962            | 161,913       | 1,107,761        | 404,381       |
| Total revenue   | 32,342,094         | 24,645,557    | 57,456,803       | 46,512,162    |
| Expenses:   |                    |               |                  |               |
| Loss and loss adjustment expense  | 9,343,158          | 12,308,775    | 16,912,001       | 19,218,772    |
| Operating and underwriting expenses                                       | 2,308,331          | 2,206,281     | 4,612,576        | 3,788,812     |
| Salaries and wages  | 1,772,511          | 1,580,120     | 3,610,472        | 3,158,701     |
| Interest expense  | 181,403            | 379,787       | 410,287          | 809,931       |
| Policy acquisition costs, net of amortization                             | 4,126,985          | 3,222,441     | 8,045,037        | 7,048,042     |
| Total expenses  | 17,732,388         | 19,697,404    | 33,590,373       | 34,024,258    |
| Income from continuing operations before provision for income tax expense | 14,609,706         | 4,948,153     | 23,866,430       | 12,487,904    |
| Provision for income tax expense  | 5,705,147          | 1,924,612     | 8,948,559        | 4,678,687     |
| Net income from continuing operations                                     | 8,904,559          | 3,023,541     | 14,917,871       | 7,809,217     |
| Discontinued operations:  |                    |               |                  |               |
| Income from discontinued operations (including gain on                    | -                  | -             | -                | 1,630,000     |

|  |              |              |               |              |  |  |  |
|--|--------------|--------------|---------------|--------------|--|--|--|
| disposal of \$0 and \$1,630,000, respectively)                           |              |              |               |              |  |  |  |
| Provision for income tax expense   | -            | -            | -             | 595,396      |  |  |  |
| Income from discontinued operations                                      | -            | -            | -             | 1,034,604    |  |  |  |
| Net income   | \$ 8,904,559 | \$ 3,023,541 | \$ 14,917,871 | \$ 8,843,821 |  |  |  |
| Basic net income per share from continuing operations                    | \$ 1.20      | \$ 0.48      | \$ 2.02       | \$ 1.27      |  |  |  |
| Basic net income per share from discontinued operations                  | \$ -         | \$ -         | \$ -          | \$ 0.16      |  |  |  |
| Basic net income per share   | \$ 1.20      | \$ 0.48      | \$ 2.02       | \$ 1.43      |  |  |  |
| Fully diluted net income per share from continuing operations            | \$ 1.19      | \$ 0.46      | \$ 1.89       | \$ 1.19      |  |  |  |
| Fully diluted net income per share from discontinued operations          | \$ -         | \$ -         | \$ -          | \$ 0.16      |  |  |  |
| Fully diluted net income per share                                       | \$ 1.19      | \$ 0.46      | \$ 1.89       | \$ 1.35      |  |  |  |
| Weighted average number of common shares outstanding                     | 7,427,765    | 6,349,182    | 7,370,592     | 6,171,134    |  |  |  |
| Weighted average number of common shares outstanding (assuming dilution) | 7,465,896    | 6,620,510    | 7,880,251     | 6,550,789    |  |  |  |
| Dividends declared per share   | \$ 0.12      | \$ 0.08      | \$ 0.24       | \$ 0.16      |  |  |  |

**SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

21<sup>ST</sup> CENTURY HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|   | <b>Six months ended June 30</b> |                           |
|---|---------------------------------|---------------------------|
|   | <b>2006</b>                     | <b>2005</b>               |
|   |                                 | Restated - See<br>note 10 |
| Cash flow from operating activities:  |                                 |                           |
| Net income  | \$ 14,917,871                   | \$ 7,809,217              |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |                           |
| Amortization of investment discount, net  | (142,788)                       | (56,786)                  |
| Depreciation and amortization of property plant and equipment, net                | 170,013                         | 240,073                   |
| Net realized investment gains   | 479,552                         | 179,744                   |
| Common Stock issued for interest on Notes   | 128,125                         | 315,625                   |
| Provision for credit losses, net  | 95,375                          | 495,881                   |
| (Recovery) for uncollectible premiums receivable                                  | (60)                            | (370,887)                 |
| Non-cash compensation   | 280,000                         | -                         |
| Changes in operating assets and liabilities:                                      |                                 |                           |
| Premiums receivable   | (2,725,621)                     | (663,746)                 |
| Prepaid reinsurance premiums  | 9,264,661                       | 5,510,379                 |
| Due from reinsurers, net  | 120,508,148                     | 3,285,572                 |
| Income taxes recoverable  | -                               | 6,151,767                 |
| Deferred income tax expense   | (2,291,513)                     | 740,252                   |
| Policy acquisition costs, net of amortization                                     | (2,760,796)                     | (1,681,114)               |
| Finance contracts receivable  | 3,493,875                       | (885,049)                 |
| Other assets  | 1,889,853                       | 664,143                   |
| Unpaid losses and loss adjustment expenses  | (122,694,416)                   | (20,544,863)              |
| Unearned premiums   | 23,177,223                      | 10,271,082                |
| Premium deposits  | 1,257,998                       | 1,237,826                 |
| Funds held under reinsurance treaties   | 24,327                          |                           |
| Income taxes payable  | 4,698,341                       | -                         |
| Bank overdraft  | (1,945,780)                     | 3,844,824                 |
| Accounts payable and accrued expenses   | 1,487,273                       | (1,255,321)               |
| Net cash provided by operating activities - continuing operations                 | 49,311,661                      | 15,288,619                |
| Net cash (used for) operating activities - discontinued operations                | -                               | (1,380,265)               |
| Net cash provided by operating activities   | 49,311,661                      | 13,908,354                |
| Cash flow (used in) investing activities:   |                                 |                           |
| Proceeds from sale of investment securities available for sale                    | 192,229,141                     | 31,747,952                |
| Purchases of investment securities available for sale                             | (226,456,356)                   | (31,624,260)              |
| Receivable for investments sold   | (17,022,140)                    |                           |
| Purchases of property and equipment   | (352,831)                       | (138,196)                 |
| Proceeds from sale of assets  | 2,662,930                       | -                         |
| Net cash (used in) investing activities - continuing operations                   | (48,939,256)                    | (14,504)                  |
| Net cash provided by investing activities - discontinued operations               | -                               | 1,689,129                 |
| Net cash (used in) provided by investing activities                               | (48,939,256)                    | 1,674,625                 |
| Cash flow provided by financing activities:                                       |                                 |                           |
| Subordinated debt repaid  | (1,666,667)                     | (1,894,792)               |
| Acquisition of common stock   | (2,000,862)                     |                           |
| Exercised stock options   | 1,417,095                       | 1,387,719                 |



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|   |              |               |
|---|--------------|---------------|
| Dividends paid  | (1,856,057)  | (1,015,214)   |
| Exercised warrants, net   | 6,060,797    | -             |
| Tax benefit related to non-cash compensation                                | 1,757,751    | -             |
| Revolving credit outstanding  | (196,943)    | (1,562,570)   |
| Net cash provided by (used in) financing activities - continuing operations | 3,515,114    | (3,084,857)   |
| Net increase in cash and cash equivalents                                   | 3,887,519    | 12,498,122    |
| Cash and cash equivalents at beginning of period                            | 6,071,460    | 6,127,706     |
| Cash and cash equivalents at end of period                                  | \$ 9,958,979 | \$ 18,625,828 |

**SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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21<sup>ST</sup> CENTURY HOLDING COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

| (continued)                                       | <b>Six months ended June 30,</b> |              |
|---|----------------------------------|--------------|
|   | <b>2006</b>                      | <b>2005</b>  |
| Supplemental disclosure of cash flow information: |                                  |              |
| Cash paid during the period for:                  |                                  |              |
| Interest  | \$ 160,215                       | \$ 292,338   |
| Non-cash investing and finance activities:        |                                  |              |
| Accrued dividends payable                         | \$ 972,276                       | \$ 446,579   |
| Retirement of subordinated debt by Common Stock   |                                  |              |
| issuance  | \$ 1,666,667                     | \$ 1,666,667 |
| Stock issued to pay interest on subordinated debt | \$ 128,125                       | \$ 315,625   |

**SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

**(1) Organization and Business**

The accompanying unaudited consolidated financial statements of 21<sup>st</sup> Century Holding Company have been prepared in accordance with generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X. These financial statements do not include all information and notes required by GAAP for complete financial statements, and should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2005. The December 31, 2005 year-end balance sheet data was derived from audited financial statements but does not include all disclosures required by GAAP. The financial information furnished reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows for the periods presented. The results of operations are not necessarily indicative of the results of operations that may be achieved in the future.

21<sup>st</sup> Century Holding Company (“21<sup>st</sup> Century,” “the Company,” “we,” “us”) is an insurance holding company, which, through our subsidiaries and our contractual relationships with our independent agents and general agents, controls substantially all aspects of the insurance underwriting, distribution and claims process. We are authorized to underwrite homeowners’ property and casualty insurance, commercial general liability insurance, and personal automobile insurance in various states with various lines of authority through our wholly owned subsidiaries, Federated National Insurance Company (“Federated National”) and American Vehicle Insurance Company (“American Vehicle”).

Federated National is authorized to underwrite personal automobile insurance, homeowners’ property and casualty insurance and mobile home property and casualty insurance in Florida as an admitted carrier. American Vehicle is authorized to underwrite personal and commercial automobile insurance and commercial general liability insurance in Florida as an admitted carrier. In addition, American Vehicle is authorized to underwrite commercial general liability insurance in Georgia, Kentucky, South Carolina and Virginia as a surplus lines carrier and in Texas, Louisiana and Alabama as an admitted carrier. American Vehicle operations in Florida, Georgia, Louisiana, Texas, South Carolina and Virginia are on-going. American Vehicle operations in Alabama and Kentucky are expected to begin this year. American Vehicle has pending applications, in various stages of approval, to be authorized as a surplus lines carrier in the states of Missouri, California and Arkansas.

During the six months ended June 30, 2006, 75.2%, 19.1% and 5.7% of the premiums we underwrote were for homeowners’ property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. During the six months ended June 30, 2005, 60.3%, 18.8% and 20.9% of the premiums we underwrote were for homeowners’ property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. We internally process claims made by our own and third-party insureds through our wholly owned claims adjusting company, Superior Adjusting, Inc. (“Superior”). We also offer premium financing to our own and third-party insureds through our wholly owned subsidiary, Federated Premium Finance, Inc. (Federated Premium”).

We market and distribute our own and third-party insurers’ products and our other services primarily in Central and South Florida, through contractual relationships with a network of approximately 1,500 independent agents and a select number of general agents.

Assurance Managing General Agents, Inc. (“Assurance MGA”), a wholly owned subsidiary, acts as Federated National’s and American Vehicle’s exclusive managing general agent in the state of Florida. As American Vehicle continues its

expansion into other states we expect to contract with other managing general agents to market our commercial general liability insurance product beyond the state of Florida. Assurance MGA currently provides all underwriting policy administration, marketing, accounting and financial services to Federated National and American Vehicle, and participates in the negotiation of reinsurance contracts. Assurance MGA generates revenue through a 6% commission fee from the insurance companies net written premium, policy fee income of \$25 per policy and other administrative fees from the marketing of companies' products through the Company's distribution network. The 6% commission fee from Federated National and American Vehicle was made effective January 1, 2005. Assurance MGA plans to establish relationships with additional carriers and add additional insurance products in the future.

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**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

**(2) Summary of Significant Accounting Policies and Practices**

**(A) Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with management's evaluation of the determination of liability for unpaid loss and loss adjustment expense ("LAE"), the amount and recoverability of amortization of deferred policy acquisition costs. In addition, significant estimates form the bases for our reserves with respect to finance contracts, premiums receivable and deferred income taxes. Various assumptions and other factors underlie the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account factors such as historical experience, current and expected economic conditions, and in the case of unpaid loss and LAE, an actuarial valuation. Management regularly reevaluates these significant factors and makes adjustments where facts and circumstances dictate. In selecting the best estimate, we utilize up to 6 different actuarial methodologies. Each of these methodologies is designed to forecast the number of claims we will be called upon to pay and the amounts we will pay on average to settle those claims. In arriving at our best estimate, our actuaries consider the likely predictive value of the various loss development methodologies employed in light of underwriting practices, premium rate changes and claim settlement practices that may have occurred, and weight the credibility of each methodology. Our actuarial methodologies take into account various factors, including, but not limited to, paid losses, liability estimates for reported losses, paid allocated loss adjustment expenses, salvage and other recoveries received, reported claim counts, open claim counts and counts for claims closed with and without payment of loss.

Accounting for loss contingencies pursuant to Statements of Financial Accounting Standards ("SFAS"), No.5 involves the existence of a condition, situation or set of circumstances involving uncertainty as to possible loss that will ultimately be resolved when one or more future event(s) occur or fail to occur. Additionally, accounting for a loss contingency requires management to assess each event as probable, reasonably possible or remote. Probable is defined as the future event or events are likely to occur. Reasonably possible is defined as the chance of the future event or events occurring is more than remote but less than probable, while remote is defined as the chance of the future event or events occurring is slight. An estimated loss in connection with a loss contingency shall be recorded by a charge to current operations if both of the following conditions are met: First, the amount can be reasonably estimated; and second, the information available prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements. It is implicit in this condition that it is probable that one or more future events will occur confirming the fact of the loss or incurrence of a liability.

**(B) Impact of New Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board ("FASB") revised SFAS No. 123, Share-Based Payments ("SFAS No. 123R"). This statement eliminates the option to apply the intrinsic value measurement provisions of the Accounting Principles Board ("APB") No. 25 to stock compensation awards issued to employees. Rather, SFAS No. 123R requires companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award the requisite service period (usually the vesting

period). SFAS No. 123R will also require companies to measure the cost of employee services received in exchange for employee stock purchase plan awards. SFAS No. 123R was effective for 21<sup>st</sup> Century's fiscal year beginning January 1, 2006 as subsequently extended by the SEC pursuant to its April 13, 2005 announcement. We have determined that the pretax charge to earnings for the year ending 2006 will total approximately \$0.6 million, of which approximately \$0.3 million was charged to income from continuing operations before provision for income taxes for the six months ended June 30, 2006. The effect on earnings per share for the six months ended June 30, 2006 for both undiluted and fully diluted was approximately \$0.04 per share. The effect on earnings per share for the three months ended June 30, 2006 for both undiluted and fully diluted was approximately \$0.02 per share. For a more detailed discussion, please see Footnote 8, titled Stock Compensation Plans.

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**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

**(C) Stock Options**

At June 30, 2006, the Company has three stock-based employee compensation plans, which are described later in footnote 8, Stock Compensation Plans. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations for the year ended December 31, 2005 as all options granted under those plans had an exercise price equal to or less than the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the first quarter of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated. On May 16, 2006, 41,000 non-qualified and 7,500 qualified stock options were issued with an option price of \$17.00 per share and a market share price of \$16.00 per share. Like all other outstanding stock options, these stock options contain service conditions and do not contain any performance conditions. For a further discussion regarding the provisions of SFAS No. 123R and its effect on our operations, please refer to footnote 8, Stock Compensation Plans.

**(D) Earnings Per Share**

Basic earnings per share (“Basic EPS”) is computed by dividing net income by the weighted average number of common shares outstanding during each period presented. Diluted earnings per share (“Diluted EPS”) is computed by dividing net income by the weighted average number of shares of common stock and common stock equivalents outstanding during the period presented; outstanding warrants and stock options are considered common stock equivalents and are included in the calculation using the treasury stock method. Additionally, when applicable, we include in our computation of the weighted average number of common shares outstanding all common stock issued in connection with the repayment of our Subordinated note.

**(E) Reclassifications**

Certain amounts in 2005 financial statements have been reclassified to conform to the 2006 presentation.

**(3) Revolving Credit Outstanding**

Federated Premium’s operations are funded by a revolving loan agreement (“Revolving Agreement”) with FlatIron Funding Company, LLC (“FlatIron”). The Revolving Agreement is structured as a sale of contracts receivable under a sale and assignment agreement with Westchester Premium Acceptance Corporation (“WPAC”), a wholly-owned subsidiary of FlatIron, which gives WPAC the right to sell or assign these contracts receivable. Federated Premium, which services these contracts, has recorded transactions under the Revolving Agreement as secured borrowings.

The amounts of WPAC’s advances are subject to availability under a borrowing base calculation, with maximum advances outstanding not to exceed the maximum credit commitment. The annual interest rate on advances under the Revolving Agreement equals the prime rate plus additional interest varying from 1.25% to 3.25% based on the prior month’s ratio of contracts receivable related to insurance companies with an A. M. Best rating of B or lower, to total

contracts receivable. The effective interest rate on this line of credit, based on our average outstanding borrowings under the Revolving Agreement, was 14.4% and 9.39% for the six months ended June 30, 2006 and 2005, respectively.

There were no outstanding borrowings under the Revolving Agreement as of June 30, 2006. Outstanding borrowings as of December 31, 2005 were approximately \$197,000. Interest expense on this revolving credit line for the six months ended June 30, 2006 and 2005 totaled approximately \$3,400 and \$28,000, respectively.

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**(4) Commitments and Contingencies**

We are involved in other claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

As a direct premium writer in the State of Florida, we are required to participate in certain insurer solvency association under Florida Statutes 631.57(3) (a). Participation in these pools is based on our written premium by line of business to total premiums written statewide by all insurers. Our participation has resulted in an assessment due to the insolvency of other property and casualty insurance carriers in the State of Florida. The assessment was approximately 2% of our 2005 net written premium in Florida and totaled \$1.9 million. The assessment was payable in July. There was no charge to operations for this assessment. We have been approved by Florida's Office of Insurance Regulation ("OIR") to recoup the assessment through a 0.9% add-on fee to all Federated National and American Vehicle policies issued in Florida with effective dates of August 15, 2006 for new business and October 15, 2006 for renewal business.

Federated National and American Vehicle are also required to participate in an insurance apportionment plan under Florida Statutes Section 627.351, which is referred to as a Joint Underwriting Plan ("JUA Plan"). The JUA Plan provides for the equitable apportionment of any profits realized, or losses and expenses incurred, among participating motor vehicle insurers. In the event of an underwriting deficit incurred by the JUA Plan, which is not recovered through the policyholders in the JUA Plan, such deficit shall be recovered from the companies participating in the JUA Plan in the proportion that the net direct written premiums of each such member during the preceding calendar year bear to the aggregate net direct premiums written in this state by all members of the JUA Plan. During the six months ended June 30, 2006, Federated National and American Vehicle were assessed approximately \$93,000 and \$2,000, respectively by the JUA Plan based on their respective Cash Activity Reports. These assessments are charged to operations as paid. Future assessments by this association are undeterminable at this time.

During its regularly scheduled meeting on August 17, 2005, the Board of Governors of Citizens Property Insurance Corporation ("Citizens") determined a 2004 plan year deficit existed in their High Risk Account. Citizen's Board decided that a \$515 million Regular Assessment is in the best interest of Citizens and consistent with Florida Statutes. On this basis, Citizen's Board certified for a Regular Assessment. Federated National's participation in this assessment totaled \$2.0 million. Provisions contained in our excess of loss reinsurance policies provide for their participation totaling \$1.5 million. Pursuant to Section 627.3512, Florida Statutes, insurers are permitted to recoup the assessment by adding a surcharge to policies in an amount not to exceed the amount paid by the insurer to Citizens. Federated National is currently underwriting the recoupment in connection with this assessment which began in March 2006. As noted above, Federated National is entitled to recoup this assessment, and will subrogate \$1.5 million to our reinsurers. Through June 30, 2006 Federated National has recouped approximately \$1.1 million in connection with this assessment. Future assessments by Citizens for a 2005 plan year deficit are assured, however no determination as to when or by how much are available at this time.

The OIR issued OIR-06-008M dated May 4<sup>th</sup> 2006 to all property and casualty insurers, surplus lines insurers, and surplus lines agents in the state of Florida placing them on notice of an anticipated Florida Hurricane Catastrophic Fund ("FHCF") assessment. Sighting the unprecedented hurricane seasons of 2004 and 2005, the FHCF has exhausted nearly all of the \$6 billion in reserves it had accumulated since its inception in 1993. The Florida State Board of Administration, the body that oversees the FHCF, has issued its directive to levy an emergency assessment upon all property and casualty business in the state of Florida. There is no statutory requirement that policyholders be notified of the FHCF assessment. The FHCF and OIR are, however, recommending that insurers include the FHCF assessment

in a line item on the declaration page for two reasons: (1) this is a multi-year assessment and (2) there may be concurrent assessments and the insureds should know what amount is for which assessment. The assessment will become effective on all policies effective after January 1, 2007 and will be remitted to the administrator of the assessment as collected.

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Effective on or about March 1, 2006, 21<sup>st</sup> Century sold its interest in the Lauderdale Lakes property to an unrelated party. As part of this transaction, 21<sup>st</sup> Century has agreed to lease the same facilities for a six year term. Our lease for this office space expires in December 2011.

The expected future lease payouts in connection with this lease are as follows:

| Fiscal Year  | Lease payments      |
|--------------|---------------------|
| 2006         | \$ 278,792          |
| 2007         | 557,583             |
| 2008         | 557,583             |
| 2009         | 557,583             |
| 2010         | 557,583             |
| Thereafter   | 557,583             |
| <b>Total</b> | <b>\$ 3,066,707</b> |

### (5) Comprehensive Income

For the three and six months ended June 30, 2006 and 2005, comprehensive income consisted of the following:

|   | Three months ended June 30, |              | Six months ended June 30, |              |
|---|-----------------------------|--------------|---------------------------|--------------|
|   | 2006                        | 2005         | 2006                      | 2005         |
| Net income  | \$ 8,904,559                | \$ 3,023,541 | \$ 14,917,871             | \$ 8,843,821 |
| Change in net unrealized gains on investments available for sale            | (535,832)                   | 458,828      | (353,572)                 | (278,738)    |
| Comprehensive income, before tax  | 8,368,727                   | 3,482,369    | 14,564,299                | 8,565,083    |
| Income tax (expense) benefit related to items of other comprehensive income | 201,634                     | (172,835)    | 133,049                   | 104,889      |
| Comprehensive income  | \$ 8,570,361                | \$ 3,309,534 | \$ 14,697,348             | \$ 8,669,972 |

### (6) Segment Information

FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information, requires that the amount reported for each segment item be based on what is used by the chief operating decision maker in formulating a determination as to how many resources to assign to a segment and how to appraise the performance of that segment. The term chief operating decision maker may apply to the chief executive officer or chief operating officer or to a group of executives. Note: The term of chief operating decision maker may apply to a function and not necessarily to a specific person. This is a management approach rather than an industry approach in identifying segments. The segments are based on the Company's organizational structure, revenue sources, nature of activities, existence of responsible managers, and information presented to the Board of Directors.

If any one of the following exists, a segment must be reported on:

- Revenue, including unaffiliated and inter-segment sales or transfers, is 10% or more of total revenue of all operating segments.
- Operating profit or loss is 10% or more of the greater, in absolute amount, of the combined operating profit (or loss) of all industry segments with operating profits (or losses).

- Identifiable assets are 10% or more of total assets of all operating segments.

Operating segments that are not reportable should be combined and disclosed in the “all other” category. Disclosure should be made of the sources of revenue for these segments.

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Accordingly, we have discontinued our segment disclosures due to the finance segment not exceeding the 10% threshold for revenues, earnings or assets.

**(7) Reinsurance Agreements**

We follow industry practice of reinsuring a portion of our risks and paying for that protection based primarily upon total insured values of all policies in effect and subject to such reinsurance. Reinsurance involves an insurance company transferring or "ceding" all or a portion of its exposure on insurance underwritten by it to another insurer, known as a "reinsurer." The ceding of insurance does not legally discharge the insurer from its primary liability for the full amount of the policies. If the reinsurer fails to meet its obligations under the reinsurance agreement, the ceding company is still required to pay for the insured the loss.

For the 2006 - 2007 hurricane season, we have assembled a range of reinsurance products designed to insure the Company for an aggregate of approximately \$414.5 million for a minimum of two catastrophic events. The reinsurance treaties contain several complex features and through a series of fluid retentions, attachment points and limitations, additional coverage may be afforded Federated National for events beyond the first two catastrophic events. Our retention will vary depending on the severity and frequency of each catastrophic event. The reinsurance companies and their respective participation in this season's program are noted in the table as follows:

| Current AM<br>Best Rating | Reinsurer                              | First Event Participation            |                                |   | Reinstated Premium<br>Protection  |                                |
|---------------------------|--|--------------------------------------|--------------------------------|---|-----------------------------------|--------------------------------|
|                           |  | \$20m<br>in<br>excess<br>of<br>\$15m | \$40m in<br>excess of<br>\$35m | \$72m in<br>excess of<br>\$75m and<br>FHCF<br>participation | \$20m in<br>excess<br>of<br>\$15m | \$40m in excess<br>of<br>\$35m |
| A+                        | Ace Tempest<br>Reinsurance Ltd         |                                      | 7.5%                           | 7.50%   |                                   |                                |
| A                         | Amlin 2001<br>Syndicate                | 5.0%                                 | 5.0%                           | 5.00%   | 5.0%                              |                                |
| A-                        | Amlin Bermuda Ltd                      | 2.5%                                 | 4.0%                           | 4.00%   | 2.5%                              |                                |
| A                         | American<br>Reinsurance<br>Company     |                                      |                                | 3.53%   |                                   |                                |
| A                         | Ascot 1414<br>Syndicate                |                                      |                                | 6.50%   |                                   |                                |
| A++                       | National Liability<br>and Fire Company |                                      | 33.8%                          | 6.57%   |                                   | 77.6%                          |
| B++                       | Converium AG                           |                                      | 5.0%                           |   |                                   |                                |
| A+                        | Everest Reinsurance<br>Company         |                                      | 22.0%                          | 4.25%   |                                   | 12.0%                          |
| NR                        | Wentworth<br>Insurance Company<br>Ltd  | 5.0%                                 |                                | .   | 5.0%                              |                                |
| A-                        | Flagstone<br>Reinsurance Ltd           |                                      | 4.3%                           | 4.00%   |                                   |                                |
| A                         |  | 2.5%                                 | 2.5%                           | 2.50%   | 2.5%                              |                                |

|     |  |       |       |        |       |
|-----|--|-------|-------|--------|-------|
|     | MAP 2791<br>Syndicate  |       |       |        |       |
| A-  | New Castle<br>Reinsurance<br>Company Ltd                                     | 2.0%  | 2.0%  | 2.00%  | 2.0%  |
| A   | QBE Reinsurance<br>Corporation   |       | 1.5%  | 1.00%  |       |
| A   | Renaissance<br>Reinsurance, Ltd  |       | 12.5% | 12.50% |       |
| A+  | XL Re Limited  |       |       | 2.50%  |       |
| A   | Odyssey  |       |       | 3.47%  |       |
| A   | Catlin Insurance<br>Company Ltd  | 25.0% |       |        | 25.0% |
| NR  | Allianz Risk<br>Transfer (Bermuda)<br>Ltd                                    | 33.0% |       |        | 33.0% |
| A   | Liberty Mutual<br>Insurance Company<br>American Vehicle<br>Insurance Company |       |       | 34.72% |       |
| NR4 | (Affiliated)   | 25.0% |       |        | 25.0% |

In the discussion that follows it should be noted that all amounts of reinsurance are based on management's current analysis of Federated National's exposure levels to catastrophic risk. Our data will be subjected to exposure level data analysis at various dates through December 31, 2006. This analysis of our exposure level in relation to the total exposures to the FHCF may produce changes in retentions, limits and reinsurance premiums as a result of increases or decreases in our exposure level.

Our overall reinsurance structure may be divided into four major layers of financial impact in connection with any single catastrophic event. The bottom layer is considered to be the first \$15 million of losses. The next layer is considered to be greater than \$15 million and less than \$35 million. The next layer is considered to be greater than \$35 million and less than \$233.3 million. The fourth layer is considered to be losses greater than \$233.3 million and less than 305.3 million.

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For first and second catastrophic events equal to or less than \$15 million, the bottom layer, Federated National will retain 100% of the first \$4.3 million and the last \$0.7 million of this bottom layer. The FHCF will participate 100% for the \$10, million in excess of Federated National's first \$4.3 million.

For the first and second catastrophic events with aggregate losses in excess of the first \$15.0 million discussed above and less than \$35 million, Federated National has acquired 100% reinsurance protection with a single automatic premium reinstatement protection provision. The \$20 million of coverage afforded in this layer is by way of 42% traditional, single season, excess of loss ("Traditional") treaties and 58% structured, multi-year, excess of loss ("Structured") treaties. As noted in the chart above, American Vehicle will reinsure Federated National via a traditional treaty for 25% of this \$20 million layer. Relative to the structured excess of loss reinsurance treaties, terms contained in these treaties afford capacity in this layer beyond the 2006 - 2007 season for two additional hurricane seasons. The structured treaties offer respective coverage for a single event in each of the three hurricane seasons and one additional respective coverage that may be applied as needed in any one of the three hurricane seasons. One of the structured treaties, representing 25% of this layer, contains a no coverage provision if any single event results in damages that exceed \$20 billion in the United States and its territories.

For the first and second catastrophic events where aggregate losses exceed \$35 million, but are less than \$233.3 million, Federated National has acquired 100% reinsurance protection through a combination of private market reinsurers and the FHCF program. The private market reinsurers have afforded coverage to insure us for \$40 million against covered losses in excess of \$35 million. The FHCF has afforded coverage to insure us for 90% of loss greater than \$55.6 million and less than \$231.5 million. The private treaties "wrap around" the FHCF treaty and afford coverage, in aggregate, for losses in excess of \$35 million and less than \$233.3 million. The FHCF treaty is an aggregate "for the entire season" treaty while the private market treaties afford respective per event coverage. As to reinstatement of coverage for the private market treaties, Federated National has purchased a single automatic premium reinstatement protection provision that would provide for an automatic reinstatement for 89% of the \$40 million coverage. Federated National would be responsible for the remaining premium reinstatement protection and the cost in connection with that reinstatement is estimated to be approximately \$2.1 million. Federated National would also be responsible for seasonal losses beyond what is afforded through this part of the FHCF coverage.

For an event where aggregate losses exceed \$233.3 million, but are less than \$305.3 million, Federated National has acquired traditional reinsurance treaties representing 65.3% of this layer without a provision for premium reinstatement protection. Premium reinstatement coverage would be prorated as to amount and if the first event exhausted this coverage Federated National would be responsible for approximately \$10.4 million for reinstatement protection. Additional coverage is afforded to Federated National via Industry Loss Warrants ("ILW"). The ILW policies provide for payments to Federated National based solely on industry wide losses to private and commercial property only in the State of Florida, notwithstanding losses incurred directly by Federated National. A payment to Federated National would only be considered, under the terms of these contracts, if wind damages incurred in the State of Florida exceeded amounts varying between \$25 billion and \$20 billion excluding public property and certain other named exclusions.

The Company is responsible for single catastrophic events with incurred losses in excess of approximately \$305 million subject to the terms of the ILW's above.

The estimated cost to the Company in connection with this reinsurance structure is approximately \$65 million and for the most part payable in quarterly installments beginning July 1, 2006 and will be amortized through earned premium in accordance with the provisions and terms contained in the respective treaties.

For the 2005-2006 hurricane season, the excess of loss treaties insured us for approximately \$64.0 million, with the Company retaining the first \$3.0 million of loss and LAE. The treaties had one full reinstatement provision for each excess layer with 100% additional premium as to time and pro rata as to amount. In addition, we purchased, from the private sector, Reinstatement Premium Protection which would reimburse the Company 100% of the cost of reinstatement for the second event. Unused coverage from the first two events carried forward to events beyond the second, in conjunction with a lowered attachment point (as explained below) afforded by the FHCF.

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In addition to the excess of loss reinsurance policies (described above), we participated in the FHCF to protect our interest in the insurable risks associated with our homeowner and mobile home owner insurance products. For the first two events, FHCF coverage began after the Company's retention of \$3.0 million and its excess of loss reinsures retention of approximately \$40.3 million.

Maximum coverage afforded from the combined policies of our FHCF and excess of loss policies in effect for varying dates from June 1, 2005 to June 30, 2006 total approximately \$194.8 million. FHCF retained approximately \$131.0 million, our excess of loss reinsurance policies retained \$64.0 million, and the Company retained the first \$3 million of insurable losses for two events. For events beyond the second largest catastrophic event during the policy term, FHCF coverage attached after the Company and its excess of loss reinsures collective retention of approximately \$15.0 million. Additionally, unused coverage from our excess of loss reinsurance treaties could have been carried forward and totaled \$20.0 million. However, loss and LAE incurred up to approximately \$15.0 million for each hurricane subsequent to Hurricane Wilma in October 2005 and through June 30, 2006 and deemed to be a catastrophic event would have been the responsibility of the Company. There were no such catastrophic events through June 30, 2005.

As a result of the loss and LAE incurred in connection with the hurricane activity that occurred in 2004 and 2005, the Company has reflected in its operations the effects of each storm as follows:

| 2004 Hurricanes            | Claim<br>Count | Gross<br>Losses       | Reinsurance<br>Recoveries | Net<br>Losses  |
|----------------------------|----------------|-----------------------|---------------------------|----------------|
|                            |                | (Dollars in millions) |                           |                |
| Charley (August 13)        | 2,570          | \$ 60.8               | \$ 50.8                   | \$ 10.0        |
| Frances (September 3)      | 3,808          | 50.7                  | 40.7                      | 10.0           |
| Ivan (September 14)        | 1,061          | 22.0                  | -                         | 22.0           |
| Jeanne (September 25)      | 1,560          | 13.2                  | -                         | 13.2           |
| <b>Total Loss Estimate</b> | <b>8,999</b>   | <b>\$ 146.7</b>       | <b>\$ 91.5</b>            | <b>\$ 55.2</b> |
|                            |                | (Dollars in millions) |                           |                |
| 2005 Hurricanes            | Claim<br>Count | Gross<br>Losses       | Reinsurance<br>Recoveries | Net<br>Losses  |
| Dennis (July 10)           | 322            | \$ 2.8                | \$ -                      | \$ 2.8         |
| Katrina (August 25)        | 2,096          | 12.3                  | 9.3                       | 3.0            |
| Rita (September 20)        | 19             | 0.1                   | -                         | 0.1            |
| Wilma (October 24)         | 11,290         | 146.1                 | 143.1                     | 3.0            |
| <b>Total Loss Estimate</b> | <b>13,727</b>  | <b>\$ 161.3</b>       | <b>\$ 152.4</b>           | <b>\$ 8.9</b>  |

We are selective in choosing a reinsurer and consider numerous factors, the most important of which are the financial stability of the reinsurer, their history of responding to claims and their overall reputation. In an effort to minimize our exposure to the insolvency of a reinsurer, we evaluate the acceptability and review the financial condition of the reinsurer at least annually.

During 2005 American Vehicle did not reinsure any of its insurance products.

**(8) Stock Compensation Plans**

We implemented a stock option plan in November 1998 that provides for the granting of stock options to officers, directors, employees and consultants. The objectives of this plan include attracting and retaining the best personnel, providing for additional performance incentives, and promoting our success by providing employees the opportunity to acquire common stock. Options outstanding under this plan have been granted at prices which are either equal to or above the market value of the stock on the date of grant, vest over a four-year period, and expire ten years after the grant date. Under this plan, we are authorized to grant options to purchase up to 900,000 common shares, and, as of June 30, 2006 and December 31, 2005, we had outstanding exercisable options to purchase 46,250 and 97,650 shares, respectively.

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In 2001, we implemented a franchise stock option plan that provides for the granting of stock options to individuals purchasing Company owned agencies which were then converted to franchised agencies. The purpose of the plan was to advance our interests by providing an additional incentive to encourage managers of Company owned agencies to purchase the agencies and convert them to franchises. Options outstanding under the plan have been granted at prices which are above the market value of the stock on the date of grant and expire ten years after the grant date. Under this plan, we are authorized to grant options to purchase up to 988,500 common shares, though in connection with our sale of our franchise operations, we do not anticipate additional options to be granted under this plan. As of June 30, 2006 and December 31, 2005, we had outstanding exercisable options to purchase -0- and 15,000 shares, respectively.

In 2002, we implemented the 2002 Option Plan. The purpose of this Plan is to advance our interests by providing an additional incentive to attract, retain and motivate highly qualified and competent persons who are key to the Company, including employees, consultants, independent contractors, officers and directors, upon whose efforts and judgment our success is largely dependent, by authorizing the grant of options to purchase Common Stock to persons who are eligible to participate hereunder, thereby encouraging stock ownership by such persons, all upon and subject to the terms and conditions of the Plan. Options outstanding under the plan have been granted at prices which are above the market value of the stock on the date of grant, vest over a five-year period, and expire six years after the grant date. Under this plan, the Company is authorized to grant options to purchase up to 1,800,000 common shares, and, as of June 30, 2006 and December 31, 2005, we had outstanding exercisable options to purchase 736,408 and 818,608 shares, respectively.

Activity in the Company's stock option plans for the period from January 1, 2005 to June 30, 2006, is summarized below:

|                                | <b>1998 Plan</b>        |   | <b>2001 Franchisee Plan</b> |   | <b>2002 Plan</b>        |   |
|--------------------------------|-------------------------|---|-----------------------------|---|-------------------------|---|
|                                | <b>Number of Shares</b> | <b>Weighted Average Option Exercise Price</b> | <b>Number of Shares</b>     | <b>Weighted Average Option Exercise Price</b> | <b>Number of Shares</b> | <b>Weighted Average Option Exercise Price</b> |
| Outstanding at January 1, 2005 | 198,275                 | \$ 6.67                                       | 15,000                      | \$ 9.17                                       | 906,300                 | \$ 10.80                                      |
| Granted                        | -                       |   | -                           |   | 451,500                 | \$ 14.39                                      |
| Exercised                      | (96,875)                | \$ 6.67                                       | -                           | \$ -  | (271,542)               | \$ 8.96                                       |
| Cancelled                      | (3,750)                 | \$ 6.67                                       | -                           |   | (262,650)               | \$ 14.00                                      |
| Outstanding at January 1, 2006 | 97,650                  | \$ 6.67                                       | 15,000                      | \$ 9.17                                       | 823,608                 | \$ 12.35                                      |
| Granted                        | -                       | \$ -  | -                           | \$ -  | 48,500                  | \$ 17.00                                      |
| Exercised                      | (51,400)                | \$ 6.67                                       | (15,000)                    | \$ 9.17                                       | (115,200)               | \$ 9.22                                       |
| Cancelled                      | -                       | \$ 6.67                                       | -                           |   | (20,500)                | \$ 13.50                                      |
| Outstanding at June 30, 2006   | 46,250                  | \$ 6.67                                       | -                           | \$ -  | 736,408                 | \$ 13.13                                      |

Options outstanding as of June 30, 2006 are exercisable as follows:

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|                           | 1998 Plan        |  | 2001 Franchisee Plan |  | 2002 Plan        |  |
|---------------------------|------------------|--|----------------------|--|------------------|--|
|                           | Number of Shares | Weighted Average Option Exercise Price | Number of Shares     | Weighted Average Option Exercise Price | Number of Shares | Weighted Average Option Exercise Price |
| Options Exercisable at:   |                  |  |                      |  |                  |  |
| June 30, 2006             | 46,250           | \$ 6.67                                | -                    | \$ -                                   | 306,958          | \$ 9.21                                |
| December 31, 2006         | -                |  | -                    |  | 55,350           | \$ 9.21                                |
| December 31, 2007         | -                |  | -                    |  | 129,200          | \$ 9.21                                |
| December 31, 2008         | -                |  | -                    |  | 95,900           | \$ 9.21                                |
| December 31, 2009         | -                |  | -                    |  | 83,900           | \$ 9.21                                |
| December 31, 2010         | -                |  | -                    |  | 57,400           | \$ 9.21                                |
| Thereafter                | -                |  | -                    |  | 7,700            |  |
| Total options exercisable | 46,250           |  | -                    |  | 736,408          |  |

At June 30, 2006, the Company has three stock-based employee compensation plans, which are described above. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations for the years ended December 31, 2005 or 2004 as all options granted under those plans had an exercise price equal to or less than the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB Statement No. 123 (R) using the modified-prospective-transition method. Under that transition method, compensation cost recognized in the first quarter of 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated.

As a result of adopting SFAS No. 123R on January 1, 2006, the Company's income from continuing operations before provision for income taxes and net income for the six months ended June 30, 2006, are lower by approximately \$280,000 and \$175,000, respectively, than if it had continued to account for share-base compensation under ABP Opinion No. 25. For the three months ended June 30, 2006, income from continuing operations before provision for income taxes and net income are lower by approximately \$123,000 and \$75,000, respectively, than if it had continued to account for share-base compensation under ABP Opinion No. 25.

Basic and diluted earnings per share for the six month period ended June 30, 2006 for both basic and diluted would have been \$2.00 and \$1.87, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of \$2.02 and \$1.89, respectively.

Basic and diluted earnings per share for the three month period ended June 30, 2006 for basic and diluted would have been \$1.19 and \$1.18, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of \$1.20 and \$1.19, respectively.

Because the change in income taxes payable includes the effect of excess tax benefits, those excess tax benefits also must be shown as a separate operating cash outflow so that operating cash flows exclude the effect of excess tax

benefits. SFAS No. 123R requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of Statement 123 to options granted under our stock option plans in the period presented. For purposes of this provision disclosure and comparability, the value of the options were estimated using the Black-Scholes option-pricing model and amortized to expense over the options vesting periods.

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|                                 | Three months<br>ended June 30,<br>2005 | Six months<br>ended June 30,<br>2005 |
|---------------------------------|--|--------------------------------------|
| Net Income as reported          | \$ 3,023,541                           | \$ 8,843,821                         |
| Compensation, net of tax effect | 145,768                                | 799,699                              |
| Pro forma net income            | \$ 2,877,773                           | \$ 8,044,122                         |
| Net income per share            |  |                                      |
| As reported - Basic             | \$ 0.48                                | \$ 1.43                              |
| As reported - Diluted           | \$ 0.46                                | \$ 1.35                              |
| Pro forma - Basic               | \$ 0.45                                | \$ 1.30                              |
| Pro forma - Diluted             | \$ 0.43                                | \$ 1.23                              |

The weighted average fair value for the 48,500 new options granted during the three months ended June 30, 2006, estimated on the date of grant using the Black-Scholes option-pricing model was \$4.67. There were no new options granted during the quarter ending March 31, 2006.

The weighted average fair value for new options granted during the six months ended June 30, 2005, estimated on the date of grant using the Black-Scholes option-pricing model was \$20.00. In connection with the sale of Express Tax Service, Inc. and EXPRESSTAX Franchise Corporation on January 1, 2005, 105,000 Incentive Stock Options under the 2002 Stock Option plan were cancelled and reissued as Non-Qualified Stock Options.

The weighted average fair value of options granted during 2005 as estimated on the date of grant using the Black-Scholes option-pricing model was \$2.81 to \$10.75 in 2005. The fair value of options granted is estimated on the date of grant using the following assumptions:

|                          | June 30, 2006    | June 30, 2005    |
|--------------------------|------------------|------------------|
| Dividend yield           | 2.80% to 3.70%   | 2.33% to 2.43%   |
| Expected volatility      | 43.97% to 44.30% | 61.76% to 96.76% |
| Risk-free interest rate  | 5.18%            | 3.34% to 3.86%   |
| Expected life (in years) | 2.04 to 2.86     | 2.59 to 2.63     |

Volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period of time. The higher the volatility, the more returns on the shares can be expected to vary - up or down. The expected volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Our volatility as reflected above contemplates only historical volatility.

Summary information about the Company's stock options outstanding at June 30, 2006:

|                     | Range of<br>Exercise Price | Outstanding<br>at<br>June 30,<br>2006 | Weighted<br>Average<br>Contractual<br>Periods in<br>Years | Weighted<br>Average<br>Exercise<br>Price | Exercisable<br>at<br>June 30,<br>2006 |
|---------------------|----------------------------|---------------------------------------|---|--|---------------------------------------|
| 1998 Plan           | \$ 6.67                    | 46,250                                | 2.53  | \$ 6.67                                  | 46,250                                |
| 2001 Franchise Plan | -                          | -                                     | -   | -  | -                                     |

|           |    |                |         |         |       |         |
|-----------|----|----------------|---------|---------|-------|---------|
| 2002 Plan | \$ | 8.33 - \$17.00 | 736,408 | 2.86 \$ | 13.13 | 306,958 |
|-----------|----|----------------|---------|---------|-------|---------|

**(9) Subordinated Debt**

On July 31, 2003, we completed a private placement of our 6% Senior Subordinated Notes (the "July 2003 Notes"), which were offered and sold to accredited investors as units consisting of one July 2003 Note with a principal amount of \$1,000 and warrants (the "2003 Warrants") to purchase shares of our Common Stock. We sold an aggregate of \$7.5 million of July 2003 Notes in this placement, which resulted in proceeds to us (net of placement agent fees of \$450,724 and offering expenses of \$110,778) of \$6,938,498.

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**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

The July 2003 Notes pay interest at the annual rate of 6%, are subordinated to senior debt of the Company, and mature on July 31, 2006. Quarterly payments of principal and interest due on the July 2003 Notes may be made in cash or, at our option, in shares of our Common Stock. If paid in shares of Common Stock, the number of shares to be issued shall be determined by dividing the payment due by 95% of the weighted-average volume price for the Common Stock on Nasdaq as reported by Bloomberg for the 20 consecutive trading days preceding the payment date.

The 2003 Warrants issued in this placement to the purchasers of the July 2003 Notes and to the placement agent in the offering, J. Giordano Securities Group (“J. Giordano”), each entitle the holder to purchase  $\frac{3}{4}$  of one share of our Common Stock at an exercise price of \$12.744 per whole share (as adjusted for the Company’s three-for-two stock split) until July 31, 2006. The total number of shares issuable upon exercise of 2003 Warrants issued to the purchasers of the July 2003 Notes and to J. Giordano totaled 612,074. GAAP requires that detachable warrants be valued separately from debt and included in paid-in capital. Based on the terms of the purchase agreement with the investors in the private placement, management determined that the July 2003 Warrants had zero value at the date of issuance.

On or about July 31, 2006, the July 2003 notes and the warrants were retired. Of the 612,074 shares that could have been issued in connection with the July 2003 notes, 301,430 were exercised and issued, 225,000 were reacquired in the open market by us and 85,644 were unexercised.

On September 30, 2004, we completed a private placement of 6% Senior Subordinated Notes due September 30, 2007 (the “September 2004 Notes”). These notes were offered and sold to accredited investors as units consisting of one September 2004 Note with a principal amount of \$1,000 and warrants to purchase shares of our Common Stock (the “2004 Warrants”), the terms of which are similar to our July 2003 Notes and 2003 Warrants, except as described below. We sold an aggregate of \$12.5 million of units in this placement, which resulted in proceeds (net of placement agent fees of \$700,000 and offering expenses of \$32,500) to us of \$11,767,500.

The September 2004 Notes pay interest at the annual rate of 6%, mature on September 30, 2007, and rank pari passu in terms of payment and priority to the July 2003 Notes. Quarterly payments of principal and interest due on the September 2004 Notes, like the July 2003 Notes, may be made in cash or, at our option, in shares of our Common Stock. If paid in shares of Common Stock, the number of shares to be issued shall be determined by dividing the payment due by 95% of the weighted-average volume price for the Common Stock on Nasdaq as reported by Bloomberg for the 20 consecutive trading days preceding the payment date.

The 2004 Warrants issued to the purchasers of the September 2004 Notes and to the placement agent in the offering, J. Giordano, each entitle the holder to purchase one share of our Common Stock at an exercise price of \$12.75 per share and will be exercisable until September 30, 2007. The number of shares issuable upon exercise of the 2004 Warrants issued to purchasers equaled \$12.5 million divided by the exercise price of the warrants, and totaled 980,392. The number of shares issuable upon exercise of the 2004 Warrants issued to J. Giordano equaled \$500,000 divided by the exercise price of the warrants, and totaled 39,216. GAAP requires that detachable warrants be valued separately from debt and included in paid-in capital. Based on the terms of the purchase agreement with the investors in the private placement, management determined that the September 2004 Warrants had zero value at the date of issuance. Of the 1,019,000 warrants issued in connection with the September 2004 notes, 539,868 have been exercised to date.

The terms of the 2004 and 2003 Warrants provide for adjustment of the exercise price and the number of shares issuable thereunder upon the occurrence of certain events typical for private offerings of this type.

As indicated on the table below, we paid, pursuant to the terms of the July 2003 Notes and in accordance with the contractual computations, the quarterly payments of principal and interest due in shares of our Common Stock.





**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

| Quarterly payment due date       | 2006          | 2005          |
|----------------------------------|---------------|---------------|
| January 31,                      | -             | 55,537        |
| April 30,                        | 38,420        | -             |
| July 31,                         | -             | -             |
| October 31,                      | -             | -             |
| <b>Total common stock issued</b> | <b>38,420</b> | <b>55,537</b> |

As indicated on the table below, we paid, pursuant to the terms of the September 2004 Notes and in accordance with the contractual computations, the quarterly payments of principal and interest due in shares of our Common Stock.

| Quarterly payment due date       | 2006          | 2005           |
|----------------------------------|---------------|----------------|
| January 31,                      | -             | 103,870        |
| April 30,                        | 68,696        | -              |
| July 31,                         | -             | -              |
| October 31,                      | -             | -              |
| <b>Total common stock issued</b> | <b>68,696</b> | <b>103,870</b> |

The Company retains the privilege of repaying these notes in cash or by the issuance of common stock. Through the quarter ended March 31, 2005, we made our quarterly installment payments by issuing common stock. Our regularly scheduled payment of principal and interest in connection with the July 2003 and September 2004 Notes were due on April 30, 2006 and were paid by issuance of 38,420 shares and 68,696 shares of our Common Stock, respectively.

For the July 2003 Notes, the quarterly principal and interest payments totaling approximately \$0.6 million per payment are due quarterly with the last installment paid in cash on July 31, 2006.

For the September 2004 Notes, the quarterly principal and interest payments, totaling approximately \$1.2 million per payment, are due quarterly for two more years with the last installment due on September 30, 2007. The scheduled loan payments for the next two years are as follows:

|                               |                     |
|-------------------------------|---------------------|
| For the period                |                     |
| Year ending December 31, 2006 | \$ 2,083,334        |
| Year ending December 31, 2007 | 4,166,666           |
| <b>Total</b>                  | <b>\$ 6,250,000</b> |

**(10) Discontinued Operations**

In 2005 the Company has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis with its continuing operations.

The Company completed the transaction contemplated by the Stock Purchase and Redemption Agreement dated January 3, 2005 with Express Tax Service, Inc. ("Express Tax"), Robert J. Kluba and Robert H. Taylor. The Company was the beneficial and record owner of 80% of the issued and outstanding stock of Express Tax, which in turn owned 100% of the issued and outstanding stock of EXPRESSTAX Franchise Corporation ("EXPRESSTAX"). Mr. Kluba was the President and a director of Express Tax and EXPRESSTAX, and the owner of the remaining 20% of the issued and outstanding stock of Express Tax. The sale of the assets closed on January 13, 2005 with an effective date of

January 1, 2005.

The Company received at closing a cash payment of \$311,351, which reflected the purchase price of \$660,000 for all of the Company's common stock in Express Tax, less \$348,649 representing intercompany receivables owed to Express Tax by the Company. The Company also received a payment of \$1,200,000 in exchange for the Company's agreement not to compete with the current business of Express Tax and EXPRESSTAX for five years following the closing. The Company's investment in its subsidiary totaled \$230,000.

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**21<sup>st</sup> Century Holding Company**  
**Notes to Consolidated Financial Statements**

In connection with the transaction, the Company has extended the expiration dates for the 75,000 outstanding stock options previously granted to Mr. Kluba and the 30,000 outstanding stock options previously granted to Mr. Kluba's wife, such that 80% of such stock options shall expire, if not exercised, on the first anniversary date of the closing and the remaining 20% of such stock options shall expire on the second anniversary date of the closing; none of these options were exercisable for the six-month period following the closing.

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## 21<sup>st</sup> Century Holding Company

*General information about 21<sup>st</sup> Century Holding Company can be found at [www.21stcenturyholding.com](http://www.21stcenturyholding.com) however, the information that can be accessed through our web site is not part of our report. We make our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports filed or furnished pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934 available free of charge on our web site, as soon as reasonably practicable after they are electronically filed with the SEC.*

### Item 2

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-Looking Statements

Statements in this report or in documents that are incorporated by reference that are not historical fact are forward-looking statements that are subject to certain risks and uncertainties that could cause actual events and results to differ materially from those discussed herein. Without limiting the generality of the foregoing, words such as “may,” “will,” “expect,” “believe,” “anticipate,” “intend,” “could,” “would,” “estimate,” or “continue” or the negative other variations of comparable terminology are intended to identify forward-looking statements. The risks and uncertainties include, without limitation, uncertainties related to estimates, assumptions and projections relating to losses from the nine hurricanes that occurred in fiscal years 2005 and 2004 and other estimates, assumptions and projections contained in this 10-Q; inflation and other changes in economic conditions (including changes in interest rates and financial markets); pricing competition and other initiatives by competitors; ability to obtain regulatory approval for requested rate changes and the timing thereof; legislative and regulatory developments; the outcome of litigation pending against us, including the terms of any settlements; risks related to the nature of our business; dependence on investment income and the composition of our investment portfolio; the adequacy of our liability for loss and loss adjustment expense; insurance agents; claims experience; ratings by industry services; catastrophe losses; reliance on key personnel; weather conditions (including the severity and frequency of storms, hurricanes, tornadoes and hail); changes in driving patterns and loss trends; acts of war and terrorist activities; court decisions and trends in litigation and health care and auto repair costs; and other matters described from time to time by us in this report, and our other filings with the SEC.

You are cautioned not to place reliance on these forward-looking statements, which are valid only as of the date they were made. The Company undertakes no obligation to update or revise any forward-looking statements to reflect new information or the occurrence of unanticipated events or otherwise. In addition, readers should be aware that GAAP prescribes when a company may reserve for particular risks, including litigation exposures. Accordingly, results for a given reporting period could be significantly affected if and when a reserve is established for a major contingency. Reported results may therefore appear to be volatile in certain accounting periods.

### Overview

The insurance industry uses terminology that is unfamiliar to many people. The Company has denoted certain terms in the footnotes to its consolidated financial statements beginning on page seven. It may be helpful for you to refer to these definitions as you read this Quarterly Report on Form 10-Q.

We are an insurance holding company, which, through our subsidiaries and our contractual relationships with our independent agents and general agents, control substantially all aspects of the insurance underwriting, distribution and claims process. We are authorized to underwrite homeowners' property and casualty insurance, commercial general liability insurance, and personal automobile insurance, in various states with various lines of authority through our wholly owned subsidiaries, Federated National and American Vehicle. We internally process claims made by our own

and third party insureds through our wholly owned claims adjusting company, Superior.

Federated National is authorized to underwrite personal automobile insurance, homeowners' property and casualty insurance and mobile home property and casualty insurance in Florida as an admitted carrier. American Vehicle is authorized to underwrite personal and commercial automobile insurance and commercial general liability insurance in Florida as an admitted carrier. In addition, American Vehicle is authorized to underwrite commercial general liability insurance in Georgia, Kentucky, South Carolina and Virginia as a surplus lines carrier and in Texas, Louisiana and Alabama as an admitted carrier. American Vehicle operations in Florida, Georgia, Louisiana, Texas, South Carolina and Virginia are on-going. American Vehicle operations in Alabama and Kentucky are expected to begin this year. American Vehicle has pending applications, in various stages of approval, to be authorized as a surplus lines carrier in the states of Missouri, California and Arkansas.

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### **21<sup>st</sup> Century Holding Company**

During the six months ended June 30, 2006, 75.2%, 19.1% and 5.7% of the premiums we underwrote were for homeowners' property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. During the six months ended June 30, 2005, 60.3%, 18.8% and 20.9% of the premiums we underwrote were for homeowners' property and casualty insurance, commercial general liability insurance and personal automobile insurance, respectively. We internally process claims made by our own and third-party insureds through our wholly owned claims adjusting company, Superior. We also offer premium financing to our own and third-party insureds through our wholly owned subsidiary, Federated Premium.

We market and distribute our own and third-party insurers' products and our other services primarily in Central and South Florida, through contractual relationships with a network of approximately 1,500 independent agents and a select number of general agents.

Assurance MGA, a wholly owned subsidiary, acts as Federated National's and American Vehicle's exclusive managing general agent. Assurance MGA currently provides all underwriting policy administration, marketing, accounting and financial services to Federated National and American Vehicle, and participates in the negotiation of reinsurance contracts. Assurance MGA generates revenue through a 6% commission fee from the insurance companies' net written premium, policy fee income of \$25 per policy and other administrative fees from the marketing of companies' products through the Company's distribution network. The 6% commission fee from Federated National and American Vehicle was made effective January 1, 2005. Assurance MGA plans to establish relationships with additional carriers and add additional insurance products in the future.

Our business, results of operations and financial condition are subject to fluctuations due to a variety of factors. Abnormally high severity or frequency of claims in any period could have a material adverse effect on our business, results of operations and financial condition. Also, if our estimated liabilities for unpaid losses and LAE are less than actual losses and LAE, we will be required to increase reserves with a corresponding reduction in our net income in the period in which the deficiency is identified.

We operate in highly competitive markets and face competition from both national and regional insurance companies, many of whom are larger and have greater financial and other resources, have better A.M. Best ratings and offer more diversified insurance coverage. Our competitors include companies which market their products through agents, as well as companies which sell insurance directly to their customers. Large national writers may have certain competitive advantages over agency writers, including increased name recognition, increased loyalty of their customer base and reduced policy acquisition costs. We may also face competition from new or temporary entrants in our niche markets. In some cases, such entrants may, because of inexperience, desire for new business or other reasons, price their insurance below ours. Although our pricing is inevitably influenced to some degree by that of our competitors, we believe that it is generally not in our best interest to compete solely on price. We compete on the basis of underwriting criteria, our distribution network and superior service to our agents and insureds.

In Florida, more than 200 companies are authorized to underwrite homeowners' insurance. Comparable companies which compete with us in the homeowners' market include Allstate Insurance Company, State Farm Insurance Company, First Floridian Insurance Company, and Vanguard Insurance Company. During the quarter ended June 30, 2006 the Florida OIR announced the take over of three of our major competitors due to the poor financial condition stemming from the effects of last year's catastrophic hurricanes. We are currently experiencing an increase in policy volume relative to our homeowners' insurance products due to the narrowed competition.

Comparable companies which compete with us in the general liability insurance market include Century Surety Insurance Company, Atlantic Casualty Insurance Company, Colony Insurance Company and Burlington/First Financial Insurance Companies.

With respect to automobile insurance in Florida, we compete with more than 100 companies, which underwrite personal automobile insurance. Comparable companies which compete with us in the personal automobile insurance market include Affirmative Insurance Holdings, Inc., which acquired our non-standard automobile agency business in Florida in December 2004, U.S. Security Insurance Company, United Automobile Insurance Company, Direct General Insurance Company and Security National Insurance Company, as well as major insurers such as Progressive Casualty Insurance Company.

Competition could have a material adverse effect on our business, results of operations and financial condition.

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## 21<sup>st</sup> Century Holding Company

Our executive offices are located at 3661 West Oakland Park Boulevard, Suite 300, Lauderdale Lakes, Florida and our telephone number is (954) 581-9993.

### Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements.

The most significant accounting estimates inherent in the preparation of our financial statements include estimates associated with our evaluation of the determination of liability for unpaid losses and LAE. In addition, significant estimates form the basis for our reserves with respect to finance contracts, premiums receivable, deferred income taxes, deferred acquisition costs and loss contingencies. Various assumptions and other factors underlie the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account factors such as historical experience, as well as current and expected economic conditions. We periodically re-evaluate these significant factors and make adjustments where facts and circumstances dictate.

Using the various complex actuarial methods and different underlying assumptions, our actuaries produce a number of point estimates for each class of business. After reviewing the appropriateness of the underlying assumptions, management selects the carried reserve for each class of business. We do not calculate a range of loss reserve estimates. Ranges are not a true reflection of the potential volatility between carried loss reserves and the ultimate settlement amount of losses incurred prior to the balance sheet date. This is due to the fact that ranges are developed based on known events as of the valuation date whereas the ultimate disposition of losses is subject to the outcome of events and circumstances that were unknown as of the valuation date.

Among the numerous factors that contribute to the inherent uncertainty in the process of establishing loss reserves are the following:

- Changes in the market and inflation rate for goods and services related to covered damages such as medical care and home repair costs,
- Changes in the judicial environment regarding the interpretation of policy provisions relating to the determination of coverage,
  - Changes in the general attitude of juries in the determination of liability and damages,
  - Legislative actions,
- Changes in our estimates of the number and/or severity of claims that have been incurred but not reported as of the date of the financial statements,
  - Changes in our underwriting standards, and
  - Any changes in our claim handling procedures.

We establish and evaluate unpaid loss reserves using recognized standard statistical loss development methods and techniques. Each component of loss reserves is affected by the expected frequency and average severity of claims. Such amounts are analyzed using statistical techniques on historical claims data and adjusted when appropriate to reflect perceived changes in loss patterns. Data is analyzed by policy coverage, jurisdiction of loss, reporting date and occurrence date, among other factors.

Average reserve amounts are established for automobile claims prior to the development of an individual case reserve. Average reserve amounts are driven by the estimated average severity per claim and the number of new claims opened.

For other than automobile lines, claims adjusters generally establish individual claim case loss and LAE reserve estimates as soon as the specific facts and merits of each claim can be evaluated. Case reserves represent the amounts, that in the judgment of the adjusters, are reasonably expected to be paid in the future to completely settle the claim, including expenses. Individual case reserves are revised as more information becomes known.

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For unreported claims, incurred but not reported (“IBNR”) reserve estimates are calculated by first projecting the ultimate number of claims expected (reported and unreported) for each significant coverage by using historical quarterly and monthly claim counts, to develop age-to-age projections of the ultimate counts by accident quarter. Reported claims are subtracted from the ultimate claim projections to produce an estimate of the number of unreported claims. The number of unreported claims is multiplied by an estimate of the average cost per unreported claim to produce the IBNR reserve amount. Actuarial techniques are difficult to apply reliably in certain situations, such as to new legal precedents, class action suits, long-term claimants from personal injury protection coverage or recent catastrophes. Consequently, supplemental IBNR reserves for these types of events may be established.

### New Accounting Pronouncements

The material set forth in Item 1, Part I, “Financial Statements - Note 2 - Summary of Significant Accounting Policies and Practices” of this Form 10-Q is incorporated herein by reference.

At June 30, 2006, the Company has three stock-based employee compensation plans, which are described in Item 1, Part I, “Financial Statements - Note 8 - Stock Compensation Plans” of this Form 10-Q. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement provisions of stock-based compensation using the intrinsic value method prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation*. Under these provisions, no stock-based employee compensation cost was recognized in the Statement of Operations for the years ended December 31, 2005 or 2004 as all options granted under those plans had an exercise price equal to or greater than the market value of the underlying common stock on the date of grant. Effective January 1, 2006, the Company adopted the fair value recognitions provisions of FASB Statement No. 123 (R) using the modified-prospective-transition method. Under that transition method, compensation cost recognized for the six months and three months ending June 30, 2006 include: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of Statement 123, totaling approximately \$117,000 and \$157,000, respectively and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair-value estimated in accordance with the provisions of SFAS No. 123R; and totaling approximately nothing and \$6,000, respectively. Results for prior periods have not been restated and there were no cumulative adjustments recorded in the March 31, 2006 Statement of Operations as a result of the adoption of FASB Statement 123 (R).

As a result of adopting SFAS No. 123R on January 1, 2006, the Company’s income from continuing operations before provision for income taxes and net income for the six months ended June 30, 2006, are lower by approximately \$280,000 and \$175,000, respectively, than if it had continued to account for share-base compensation under ABP Opinion No. 25. For the three months ended June 30, 2006, income from continuing operations before provision for income taxes and net income are lower by approximately \$123,000 and \$75,000, respectively, than if it had continued to account for share-base compensation under ABP Opinion No. 25.

Basic and diluted earnings per share for the six month period ended June 30, 2006 for basic and diluted would have been \$2.00 and \$1.87, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of \$2.02 and \$1.89, respectively.

Basic and diluted earnings per share for the three month period ended June 30, 2006 for basic and diluted would have been \$1.19 and \$1.18, respectively, if the Company had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of \$1.20 and \$1.19, respectively.

Our estimate for compensation cost related to non-vested awards not yet recognized as of January 1, 2006 total approximately \$1.7 million and the weighted average period over which it is expected to be recognized ranges between 2.6 and 2.82 years.

The weighted average fair value for the 48,500 new options granted during the three months ended June 30, 2006, estimated on the date of grant using the Black-Scholes option-pricing model was \$4.67. There were no new options granted during the quarter ended March 31, 2006. The weighted average fair value for new options granted during the six months ended June 30, 2005, estimated on the date of grant using the Black-Scholes option-pricing model was \$20.00. The fair value of options granted is estimated on the date of grant using the following assumptions:

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### 21<sup>st</sup> Century Holding Company

|                          | June 30, 2006    | June 30, 2005    |
|--------------------------|------------------|------------------|
| Dividend yield           | 2.80% to 3.70%   | 2.33% to 2.43%   |
| Expected volatility      | 43.97% to 44.30% | 61.76% to 96.76% |
| Risk-free interest rate  | 5.18%            | 3.34% to 3.86%   |
| Expected life (in years) | 2.04 to 2.86     | 2.59 to 2.63     |

Volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period of time. The higher the volatility, the more the returns on the shares can be expected to vary - up or down. The expected volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Our volatility as reflected above contemplates only historical volatility.

There were no changes in the quantity or type of instruments used in the share-based payment programs, such as a shift from share options to restricted shares. Additionally, there were no changes in the terms of the share-based payment arrangements, such as the addition of performance conditions.

On December 5, 2005, our Board of Directors granted a modification to the outstanding share-based stock options prior to the adoption of SAFS 123 (R). The modification provided that the grant price for 92,000 outstanding share-based stock options under the 2002 Stock Option Plan (both vested and unvested) be repriced from \$20.00 per share as originally issued to a new grant price of \$16.00 per share. All other features of the stock options were unchanged. At the close of business on the date of the modification the company's common stock traded at \$14.35 per share. The effect of the modification to these stock options was reflected in the pro forma disclosure for the period ended December 31, 2005. The reason for the reprice was to reinstate the desired motivational effect and provide a refreshed incentive to the holders of those stock options.

#### Analysis of Financial Condition

##### As of June 30, 2006 as Compared to December 31, 2005

#### Total Investments

SFAS No. 115 addresses accounting and reporting for (a) investments in equity securities that have readily determinable fair values and (b) all investments in debt securities. SFAS 115 requires that these securities be classified into one of three categories, Held-to-maturity, Trading securities or Available-for-sale.

Investments classified as held-to-maturity include debt securities wherein the Company's intent and ability are to hold the investment until maturity. The accounting treatment for held-to-maturity investments is to carry them at amortized cost without consideration to unrealized gains or losses. Investments classified as trading securities include debt and equity securities bought and held primarily for the sale in the near term. The accounting treatment for trading securities is to carry them at fair value with unrealized holding gains and losses included in current period operations. Investments classified as available-for-sale include debt and equity securities that are not classified as held-to-maturity or as trading security investments. The accounting treatment for available-for-sale securities is to carry them at fair value with unrealized holding gains and losses excluded from earnings and reported as a separate component of shareholders' equity, namely "Other Comprehensive Income".

Total Investments increased \$33.7 million, or 33.6%, to \$133.8 million as of June 30, 2006, as compared to \$100.1 million as of December 31, 2005. The increase is primarily a result of our investment of the proceeds from an increase in written insurance premiums.

The fixed maturities and the equity securities that are available for sale and carried at fair value represent 85.3% of total investments as of June 30, 2006, as compared to 80.3% as of December 31, 2005.

We did not hold any non-traded investment securities during 2006 or 2005.

Below is a summary of net unrealized gains and (losses) at June 30, 2006 and December 31, 2005 by category.

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|  | <b>Unrealized Gains and (Losses)</b> |                          |
|--|--------------------------------------|--------------------------|
|  | <b>June 30, 2006</b>                 | <b>December 31, 2005</b> |
| <b>Fixed maturities:</b>                           |                                      |                          |
| U.S. government obligations and agency obligations | \$ (1,310,967)                       | \$ (618,703)             |
| Obligations of states and political subdivisions   | (328,185)                            | (135,305)                |
|  | (1,639,152)                          | (754,008)                |
| <b>Corporate securities:</b>                       |                                      |                          |
| Communications                                     | 3,401                                | 14,735                   |
| Financial  | (81,665)                             | (225,768)                |
| Other  | (20,893)                             | (19,681)                 |
|  | (99,157)                             | (230,714)                |
| <b>Equity securities:</b>                          |                                      |                          |
| Common stocks                                      | (1,079,979)                          | (1,479,994)              |
| <b>Total unrealized gains and (losses), net</b>    | <b>\$ (2,818,288)</b>                | <b>\$ (2,464,716)</b>    |

During December 2005, we classified \$19.7 million of our bond portfolio as held-to-maturity. The decision to classify this layer of our bond portfolio as held-to-maturity was predicated on our intention to establish an irrevocable letter of credit in order to facilitate business opportunities in connection with our commercial general liability program. During April 2006, American Vehicle finalized the irrevocable letter of credit in conjunction with the 100% Quota Share Reinsurance Agreement with Republic Underwriters Insurance Company.

Pursuant to FASB 115, the Company records the unrealized losses, net of estimated income taxes that are associated with that part of our portfolio classified as available for sale through the Shareholders' equity account titled Other Comprehensive Income. Management periodically reviews the individual investments that comprise our portfolio in order to determine whether a decline in fair value below our cost is either other than temporary or permanently impaired. Factors used in such consideration include, but are not limited to, the extent and length of time over which the market value has been less than cost, the financial condition and near-term prospects of the issuer and our ability and intent to keep the investment for a period sufficient to allow for an anticipated recovery in market value.

In reaching a conclusion that a security is either other than temporary or permanently impaired we consider such factors as the timeliness and completeness of expected dividends, principle and interest payments, ratings from nationally recognized statistical rating organizations such as Standard and Poor's and Moody's as well as information released via the general media channels.

The investments held at June 30, 2006 and December 31, 2005 were comprised mainly of United States government and agency bonds as well as municipal bonds which are viewed by the Company as conservative and less risky holdings however, sensitive to interest rate changes. There is a smaller concentration of corporate bonds predominantly held in the financial and conglomerate industries. Approximately two-thirds of the equity holdings are in income funds while the other third is invested in equities related to the mortgage investment industry and business service industry.

All of our securities are in good standing and are not impaired as defined by FASB 115. We have determined that none of our securities qualify for other than temporary impairment or permanent impairment status. Our rationale for

this determination includes, but is not limited to Standard and Poor's rating of no less than BB++, no delinquent interest and dividend payments, near term maturity dates and our ability and intent to hold these securities for a period sufficient to allow for an anticipated recovery in market value.

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## 21<sup>st</sup> Century Holding Company

### Cash and Cash Equivalents

Cash and cash equivalents, which include cash, certificates of deposits, and money market accounts increased \$3.9 million, or 64.0%, to \$10.0 million as of June 30, 2006, as compared to \$6.1 million as of December 31, 2005. These balances are held primarily in money market accounts and are available for the settlement of hurricanes related claims.

### Receivable for Investments Sold

Receivable for investments sold increased to \$17.0 million as of June 30, 2006, as compared to nothing as of December 31, 2005. The increase is a result of investment trading activity that occurred in late June 2006 and did not settle until early July 2006.

### Finance Contracts Receivable, Net of Allowance for Credit Losses

Finance contracts receivable, net of allowance for credit losses, decreased \$3.6 million, or 49.1%, to \$3.7 million as of June 30, 2006, as compared to \$7.3 million as of December 31, 2005. The decrease is primarily due to our sale in December 2004 of our assets related to our non-standard automobile insurance agency business in Florida and the associated financed contracts. We anticipate a continued decline in the financed contracts receivable, net over the future short term and its related conversion to cash, cash equivalents and investments.

### Prepaid Reinsurance Premiums

Prepaid reinsurance premiums decreased \$9.3 million, or 76.4%, to \$2.9 million as of June 30, 2006, as compared to \$12.1 million as of December 31, 2005. The decrease is due to the amortization of prepaid reinsurance premiums associated with our homeowners' book of business.

### Premiums Receivable, Net of Allowance for Credit Losses

Premiums receivable, net of allowance for credit losses, increased \$2.7 million, or 36.3%, to \$10.2 million as of June 30, 2006, as compared to \$7.5 million as of December 31, 2005.

The largest component of the increase relates to our expanding homeowners' insurance business for which premiums receivable increased \$2.9 million, or 152.6%, to \$4.9 million as of June 30, 2006, as compared to \$1.9 million as of December 31, 2005. The increase in the homeowner's receivable is due to the Company's success in expanding homeowner's written premium to new customers and the implementation of overall rate increases.

Additional components of the premium receivable include amounts in connection with our commercial general liability insurance business which increased \$0.9 million, or 38.7%, to \$3.1 million as of June 30, 2006, as compared to \$2.3 million as of December 31, 2005.

Premiums receivable in connection with our automobile line of business decreased \$1.1 million, or 25.2%, to \$3.1 million as of June 30, 2006, as compared to \$4.2 million as of December 31, 2005. The decrease in automobile related premiums receivable is associated with the sale of our distribution channels in connection with the sale of our agencies, effective December 31, 2004.

### Reinsurance Recoverable

Reinsurance recoverable decreased \$120.5 million, or 88.2%, to \$16.2 million as of June 30, 2006, as compared to \$136.7 million as of December 31, 2005. The decrease is due to the timing of settlements with our reinsurers in connection with the adjustment of loss and LAE claims as they relate to costs recoverable under our reinsurance agreements. All amounts are considered current; the private reinsurance recoverable is collateralized by irrevocable letters of credit in favor of Federated National.

**Deferred Policy Acquisition Costs**

Deferred policy acquisition costs increased \$2.8 million, or 30.1%, to \$11.9 million as of June 30, 2006, as compared to \$9.2 million as of December 31, 2005. The increased production volume for both the homeowners' and commercial general liability product lines is the reason for the modest increase to this asset.

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## 21<sup>st</sup> Century Holding Company

### Deferred Income Taxes, net

Deferred income taxes, net, increased \$2.3 million, or 84.8%, to \$5.0 million as of June 30, 2006, as compared to \$2.7 million as of December 31, 2005. The increase is comprised primarily of \$2.4 million related to discounted unearned premiums and \$0.9 million in connection with the sale of our property in Lauderdale Lakes, offset by \$1.0 million associated with deferred policy acquisition costs.

### Property, Plant and Equipment, net

Property, plant and equipment, net, decreased \$2.5 million, or 63.6%, to \$1.4 million as of June 30, 2006, as compared to \$3.9 million as of December 31, 2005. Effective on or about March 1, 2006, 21<sup>st</sup> Century sold its interest in the Lauderdale Lakes property to an unrelated party for approximately \$5.0 million cash and a \$0.9 million six year 5% note, generating a gain on sale totaling approximately \$2.9 million. As part of the transaction, 21<sup>st</sup> Century has agreed to lease the same facilities for a six year term. Our lease for this office space expires in February 2011. The Company recognized a deferred gain in connection with the sale totaling approximately \$2.8 million.

### Other Assets

Other assets increased \$0.8 million, or 17.3%, to \$5.4 million as of June 30, 2006, as compared to \$4.6 million as of December 31, 2005. Major components of other assets are as follows:

|   | June 30, 2006       | December 31, 2005   |
|---|---------------------|---------------------|
| Accrued interest income                       | \$ 1,006,385        | \$ 734,059          |
| Notes receivable                              | 889,583             | -                   |
| Unamortized loan costs                        | 155,552             | 310,832             |
| Compensating cash balances                    | 9,359               | 363,021             |
| Due from sale of discontinued operations, net | -                   | 410,000             |
| Prepaid expenses                              | 364,445             | 349,138             |
| Recoupment of assessments                     | 2,910,324           | 2,025,210           |
| Other   | 35,502              | 387,803             |
| <b>Total</b>                                  | <b>\$ 5,371,150</b> | <b>\$ 4,580,063</b> |

### Unpaid Losses and LAE

Unpaid losses and LAE decreased \$122.7 million, or 79.7%, to \$31.3 million as of June 30, 2006, as compared to \$154.0 million as of December 31, 2005. The decrease in unpaid losses and LAE relates to our payment patterns primarily relative to the settling of hurricane related claims. The composition of unpaid loss and LAE by product line is as follows:

|                              | June 30, 2006        | December 31, 2005     |
|------------------------------|----------------------|-----------------------|
| Homeowners'                  | \$ 15,937,780        | \$ 135,173,026        |
| Commercial general liability | 4,474,457            | 3,661,256             |
| Automobile                   | 10,931,890           | 15,204,261            |
|                              | <b>\$ 31,344,127</b> | <b>\$ 154,038,543</b> |

Factors that affect unpaid losses and LAE include the estimates made on a claim-by-claim basis known as "case reserves" coupled with bulk estimates known as IBNR. Periodic estimates by management of the ultimate costs required to settle all claim files are based on the Company's analysis of historical data and estimations of the impact of

numerous factors such as (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and changes in political attitudes; and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based on the results of its analysis. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors.

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## 21<sup>st</sup> Century Holding Company

### Unearned Premium

Unearned premiums increased \$23.2 million, or 37.5%, to \$85.0 million as of June 30, 2006, as compared to \$61.8 million as of December 31, 2005. The increase was due to a \$22.6 million increase in unearned homeowners' insurance premiums, a \$4.1 million increase in unearned commercial general liability premiums, and a \$3.5 million decrease in unearned automobile premiums. These changes reflect our continued emphasis in 2006 on property and commercial general liability insurance products.

### Premium Deposits

Premium deposits increased \$1.3 million, or 58.7%, to \$3.4 million as of June 30, 2006, as compared to \$2.1 million as of December 31, 2005. Premium deposits are monies received on policies not yet in force as of June 30, 2006. The change is due to our policyholders purchasing patterns, the Company's marketing efforts and our policies renewal patterns.

### Revolving Credit Outstanding

Revolving credit outstanding decreased to nothing as of June 30, 2006, as compared to \$0.2 million as of December 31, 2005. The decrease is due to our cash management efforts, requested credit reduction from the lender, and sale in December 2004 of our assets related to our non-standard automobile insurance agency business in Florida and the derived finance contracts receivable.

### Bank Overdraft

Bank overdraft decreased \$1.9 million, or 15.9%, to \$10.3 million as of June 30, 2006, as compared to \$12.2 million as of December 31, 2005. The bank overdraft relates to hurricane-related loss and LAE disbursements paid but not yet presented for payment by the policyholder or vendor. The decrease relates to our payment patterns in relationship to the rate at which those cash disbursements are presented to the bank for payment.

### Funds Held Under Reinsurance Treaties

Funds held under reinsurance treaties remained relatively unchanged at \$1.6 million as of June 30, 2006, as compared to \$1.5 million as of December 31, 2005. During its regularly scheduled meeting on August 17, 2005, the Board of Governors of Citizens determined a 2004 plan year deficit existed in their High Risk Account. Citizen's Board decided that a \$515 million Regular Assessment was in the best interest of Citizens and consistent with Florida Statutes. On this basis, Citizen's Board certified for a Regular Assessment. Federated National's participation in this assessment totaled \$2.0 million. Provisions contained in our excess of loss reinsurance policies provide for their participation totaling \$1.5 million of our \$2.0 million assessment. Pursuant to Section 627.3512, Florida Statutes, insurers are permitted to recoup the assessment by adding a surcharge to policies in an amount not to exceed the amount paid by the insurer to Citizens. Federated National is currently underwriting the recoupment in connection with this assessment which began during the later part of the first quarter of 2006. As noted above, Federated National is entitled to recoup this assessment, and will subrogate \$1.5 million to our reinsurers.

### Income Taxes Payable

Income taxes payable increased \$4.7 million, or 155.6%, to \$7.7 million as of June 30, 2006, as compared to \$3.0 million as of December 31, 2005. The increase is due to the one time gain in connection with the sale of our property in Lauderdale Lakes and our continued profitable operations.

**Subordinated Debt**

Subordinated debt decreased \$3.3 million, or 32.7%, to \$6.9 million as of June 30, 2006, as compared to \$10.2 million as of December 31, 2005. The decrease is in connection with the scheduled quarterly principle payments.

**Deferred Gain from Sale of Property**

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Deferred gain from sale of property increased to \$2.8 million as of June 30, 2006 as compared to nothing as of December 31, 2005. In accordance with the provisions of FASB No. 13, we will amortize the deferred gain over the term of the lease-back which is scheduled to end in December 2011.

### Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses increased \$1.5 million, or 35.8%, to \$5.6 million as of June 30, 2006, as compared to \$4.2 million as of December 31, 2005. The increase is due to our cash management efforts and timing of payments with our trade vendors.

### Results of Operations

#### Three Months Ended June 30, 2006 as Compared to Three Months Ended June 30, 2005

#### Gross Premiums Written

Gross premiums written increased \$19.4 million, or 61.8%, to \$50.8 million for the three months ended June 30, 2006, as compared to \$31.4 million for the three months ended June 30, 2005. The following table denotes gross premiums written by major product line.

|                               | 2006                 |                | 2005                 |                |
|-------------------------------|----------------------|----------------|----------------------|----------------|
|                               | Amount               | Percentage     | Amount               | Percentage     |
| Automobile                    | \$ 660,317           | 1.30%          | \$ 3,829,250         | 12.21%         |
| Homeowners'                   | 41,855,449           | 82.47%         | 21,163,250           | 67.48%         |
| Commercial liability          | 8,236,906            | 16.23%         | 6,370,408            | 20.31%         |
| <b>Gross written premiums</b> | <b>\$ 50,752,672</b> | <b>100.00%</b> | <b>\$ 31,362,908</b> | <b>100.00%</b> |

As noted above, the Company's efforts to expand commercial general liability lines of insurance products are coming to fruition, as reflected by increased premiums written of \$1.9 million, or 29.3 % to \$8.2 million for the three months ended June 30, 2006, as compared to \$6.4 million for the same three month period last year.

The following table sets forth the amounts and percentages of our gross premiums written in connection with our commercial general liability program by state:

| State        | 2006                |               | 2005                |               |
|--------------|---------------------|---------------|---------------------|---------------|
|              | Amount              | Percentage    | Amount              | Percentage    |
| Florida      | \$ 6,174,391        | 75.1%         | \$ 5,475,418        | 85.9%         |
| Georgia      | 234,864             | 2.8%          | 332,163             | 5.3%          |
| Louisiana    | 1,536,053           | 18.6%         | 562,827             | 8.8%          |
| Texas        | 291,598             | 3.5%          | -                   | 0.0%          |
| <b>Total</b> | <b>\$ 8,236,906</b> | <b>100.0%</b> | <b>\$ 6,370,408</b> | <b>100.0%</b> |

The Company's sale of homeowners' policies increased \$20.7 million, or 98.1% to \$41.8 million for the three months ended June 30, 2006, as compared to \$21.1 million in the same three months ended June 30, 2005. The increase in

homeowners' gross premiums written is primarily due to the Company's rate increase and the addition of new customers.

The Company's sale of auto insurance policies decreased by \$3.2 million, or 82.8% to \$0.7 million for the three months ended June 30, 2006, as compared to \$3.8 million in the same three months ended June 30, 2005.

**Gross Premiums Ceded**

Gross premiums ceded increased to a debit balance of (\$3.4) million for the three months ended June 30, 2006, as compared to a debit balance of (\$2.1) million for the three months ended June 30, 2005. The increase is associated with the change in our prepaid reinsurance premiums.

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### Decrease in Prepaid Reinsurance Premiums

The decrease in prepaid reinsurance premiums was \$0.6 million for the three months ended June 30, 2006, as compared to \$2.8 million for the three months ended June 30, 2005. The decreased charge against written premium is primarily associated with the timing of our reinsurance payments measured against the term of the underling reinsurance policies.

### (Increase) in Unearned Premiums

The (increase) in unearned premiums was (\$18.0) million for the three months ended June 30, 2006, as compared to (\$4.6) million for the three months ended June 30, 2005. The change was due to a \$19.5 million increase in unearned homeowners' insurance premiums, a \$1.7 million increase in unearned commercial general liability premiums, a \$3.2 million decrease in unearned automobile premiums, and a \$0.1 million decrease in unearned mobile home insurance premiums. These changes reflect our continued growth along our homeowners' and commercial general liability lines of business. For further discussion, see "Unearned Premiums" above.

### Finance Revenue

Finance revenue decreased \$0.4 million, or 47.1%, to \$0.5 million for the three months ended June 30, 2006, as compared to \$0.9 million for the three months ended June 30, 2005. The decrease is primarily due to the sale in December 2004 of our assets related to our non-standard automobile insurance agency business in Florida and the finance revenue derived there-from.

### Managing General Agent Fees

Managing general agent fees increased \$0.1 million, or 16.6%, to \$0.7 million for the three months ended June 30, 2006, as compared to \$0.6 million for the three months ended June 30, 2005. The increase is associated with the number of policies issued during the respective periods.

### Net Investment Income

Net investment income increased \$0.7 million, or 77.0%, to \$1.6 million for the three months ended June 30, 2006, as compared to \$0.9 million for the three months ended June 30, 2005. The increase in investment income is primarily a result of the additional amounts of invested assets. Also affecting our net investment income was an increase in overall yield to 5.34% for the three months ended June 30, 2006 as compared to a yield of 4.44% for the three months ended June 30, 2005.

### Net Realized Investment Gains

Net realized investment gains increased \$0.2 million, or 125.8% to \$0.3 million for the three months ended June 30, 2006, as compared to \$0.1 million for the three months ended June 30, 2005. The table below depicts the gains by investment category.

|  | <b>Net Realized Gains (Losses)</b> |             |
|--|------------------------------------|-------------|
|  | <b>Three Months Ended June 30,</b> |             |
|  | <b>2006</b>                        | <b>2005</b> |
| Fixed maturities:                        |                                    |             |
| U.S. government obligations and agencies | \$ (32,516)                        | \$ -        |

Corporate securities:

|       |   |        |
|-------|---|--------|
| Other | - | 21,525 |
|-------|---|--------|

Equity securities:

|               |         |         |
|---------------|---------|---------|
| Common stocks | 315,857 | 103,985 |
|---------------|---------|---------|

|                          |            |            |
|--------------------------|------------|------------|
| Total net realized gains | \$ 283,341 | \$ 125,510 |
|--------------------------|------------|------------|

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### Other Income

Other income increased \$0.3 million, or 200.8%, to \$0.5 million for the three months ended June 30, 2006, as compared to \$0.2 million for the three months ended June 30, 2005. Major components of other income for the three months ended June 30, 2006 included approximately \$153,000 in connection with our business interruption insurance proceeds stemming from Hurricane Wilma, \$132,000 of commissions in connection with the national flood insurance program, \$123,000 of commissions in connection with the acquisition of our current reinsurance program and \$115,000 in connection with the recognition of our gain on the sale of our Lauderdale Lakes property

### Loss and LAE

Loss and LAE, our most significant expense, represent actual payments made and changes in estimated future payments to be made to or on behalf of our policyholders, including expenses required to settle claims and losses. We revise our estimates based on the results of analysis of estimated future payments to be made. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events

Loss and LAE decreased by \$3.0 million, or 24.1%, to \$9.3 million for the three months ended June 30, 2006, as compared to \$12.3 million for the three months ended June 30, 2005. The decrease is attributable to the increase in loss and LAE incurred during the three months ended June 30, 2005 which was in connection with the adverse development associated with the 2004 hurricanes.

We continue to revise our estimates of the ultimate financial impact of past storms. The revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based on the results of its analysis. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors.

The table below reflects no effect to operations during the three months ended June 30, 2006 from the four hurricanes that occurred in July, August, September and October of 2005. As to Hurricane Wilma, despite the increase in claim count during the three months ended June 30, 2006, gross losses and reinsurance recoveries have increased by \$8.3 million due primarily to an increase in average severity per claim.

| 2005 Hurricanes            | Claim<br>Count | Gross<br>Losses | Reinsurance<br>Recoveries | Net<br>Losses |
|----------------------------|----------------|-----------------|---------------------------|---------------|
|                            |                |                 | (Dollars in millions)     |               |
| Dennis (July 10)           | 2              | \$ -            | \$ -                      | \$ -          |
| Katrina (August 25)        | 2              | -               | -                         | -             |
| Rita (September 20)        | -              | -               | -                         | -             |
| Wilma (October 24)         | 252            | 8.3             | 8.3                       | -             |
| <b>Total Loss Estimate</b> | 256            | \$ 8.3          | \$ 8.3                    | \$ -          |

The following table reflects the changes during the three months ended June 30, 2006 in connection with the four hurricanes that occurred in August and September of 2004. A charge of \$1.1 million occurred during the three months ended June 30, 2006 in connection with these storms.

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| 2004 Hurricanes       | Claim<br>Count | Gross<br>Losses | Reinsurance<br>Recoveries |      | Net<br>Losses |
|-----------------------|----------------|-----------------|---------------------------|------|---------------|
|                       |                |                 | (Dollars in millions)     |      |               |
| Charley (August 13)   | 3              | \$ 1.3          | \$ 1.3                    | \$ - | -             |
| Frances (September 3) | 3              | 0.5             | 0.5                       | -    | -             |
| Ivan (September 14)   | -              | 1.0             | -                         | -    | 1.0           |
| Jeanne (September 25) | 3              | 0.1             | -                         | -    | 0.1           |
| Total Loss Estimate   | 9              | \$ 2.9          | \$ 1.8                    | \$ - | 1.1           |

Our loss ratio, as determined in accordance with GAAP, for the three month period ended June 30, 2006 was 32.51% compared with 56.23% for the same period in 2005. The table below reflects the loss ratios by product line.

|                      | Three months ended June 30, |        |
|----------------------|-----------------------------|--------|
|                      | 2006                        | 2005   |
| Automobile           | 97.21%                      | 71.91% |
| Homeowners'          | 25.91%                      | 62.14% |
| Commercial liability | 13.11%                      | 20.79% |
| All lines            | 32.51%                      | 56.23% |

For further discussion, see the Note 7 to the Consolidated Financial Statements included under Part I, Item 1, of this Report.

### Operating and Underwriting Expenses

Operating and underwriting expenses increased a modest \$0.1 million, or 4.6%, to \$2.3 million for the three months ended June 30, 2006, as compared to \$2.2 million for the three months ended June 30, 2005.

### Salaries and Wages

Salaries and wages increased \$0.2 million, or 12.2%, to \$1.8 million for the three months ended June 30, 2006, as compared to \$1.6 million for the three months ended June 30, 2005. As a result of adopting SFAS No. 123R on January 1, 2006, salaries and wages for the three months ended June 30, 2006 increased \$123,000, representing approximately 64.0% of the 2006 second quarter's overall increase. The remaining increase in salaries and wages was due in part to the increased labor costs in connection with additional claims loss adjusters added to our staff. We believe that salaries and wages are consistent with retaining quality management and increased premium production.

### Interest Expense

Interest expense decreased \$0.2 million, or 52.2%, to \$0.2 million for the three months ended June 30, 2006, as compared to \$0.4 million for the three months ended June 30, 2005. The change is primarily attributed to our decreased reliance upon outside sources for financing our contracts receivable.

### Policy Acquisition Costs, Net of Amortization

Policy acquisition costs, net of amortization, increased \$0.9 million, or 28.1%, to \$4.1 million for the three months ended June 30, 2006, as compared to \$3.2 million for the three months ended June 30, 2005. Policy acquisition costs,

net of amortization, consists of the actual policy acquisition costs, including commissions, payroll and premium taxes, less commissions earned on reinsurance ceded and policy fees earned.

**Provision for Income Tax Expense**

The provision for income tax expense for continuing and discontinued operations increased \$3.8 million, or 196.4%, to \$5.7 million for the three months ended June 30, 2006, as compared to \$1.9 million for the three months ended June 30, 2005. The effective rate for income tax expense is 39.1% for the three months ended June 30, 2006, as compared to 38.9% for the same three month period in 2005.

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As a result of the foregoing, the Company's net income for the three months ended June 30, 2006 was \$8.9 million compared to net income of \$3.0 million for the three months ended June 30, 2005.

### Results of Operations

#### Six Months Ended June 30, 2006 as Compared to Six Months Ended June 30, 2005

#### Gross Premiums Written

Gross premiums written increased \$24.9 million, or 40.5%, to \$86.4 million for the six months ended June 30, 2006, as compared to \$61.5 million for the six months ended June 30, 2005. The following table denotes gross premiums written by major product line.

|                        | Six months ended June 30, |            |               |            |
|------------------------|---------------------------|------------|---------------|------------|
|                        | 2006                      |            | 2005          |            |
|                        | Amount                    | Percentage | Amount        | Percentage |
| Automobile             | \$ 4,946,651              | 5.73%      | \$ 12,847,495 | 20.90%     |
| Homeowners'            | 64,957,975                | 75.21%     | 37,086,287    | 60.35%     |
| Commercial liability   | 16,457,119                | 19.06%     | 11,526,170    | 18.75%     |
| Gross written premiums | \$ 86,361,745             | 100.00%    | \$ 61,459,952 | 100.00%    |

As noted above, the Company's efforts to expand commercial general liability lines of insurance products are coming to fruition, as reflected by increased premiums written of \$4.9 million, or 42.8 % to \$16.5 million for the six months ended June 30, 2006, as compared to \$11.5 million for the same six month period last year.

The following table sets forth the amounts and percentages of our gross premiums written in connection with our commercial general liability program by state:

| State                  | Six months ended June 30, |            |           |            |
|------------------------|---------------------------|------------|-----------|------------|
|                        | 2006                      |            | 2005      |            |
|                        | Amount                    | Percentage | Amount    | Percentage |
| (Dollars in Thousands) |                           |            |           |            |
| Florida                | \$ 12,741                 | 77.5%      | \$ 9,994  | 86.6%      |
| Georgia                | 570                       | 3.4%       | 537       | 4.8%       |
| Louisiana              | 2,854                     | 17.3%      | 995       | 8.6%       |
| Texas                  | 292                       | 1.8%       | -         | 0.0%       |
| Total                  | \$ 16,457                 | 100.0%     | \$ 11,526 | 100.0%     |

The Company's sale of homeowners' policies increased \$27.9 million, or 43.1%, to \$64.7 million for the six months ended June 30, 2006, as compared to \$36.8 million in the same six months ended June 30, 2005. The increase in homeowners' gross premiums written is primarily due to the Company's rate increase and the addition of new customers.

The Company's sale of auto insurance policies decreased by \$7.9 million, or 61.5%, to \$4.9 million for the six months ended June 30, 2006, as compared to \$12.8 million in the same six months ended June 30, 2005.

#### Gross Premiums Ceded

Gross premiums ceded decreased to a debit balance of (\$3.4) million for the six months ended June 30, 2006, as compared to a debit balance of (\$5.0) million for the six months ended June 30, 2005. The decrease is associated with the change in our prepaid reinsurance premiums.

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### Decrease in Prepaid Reinsurance Premiums

The decrease in prepaid reinsurance premiums was \$9.3 million for the six months ended June 30, 2006, as compared to \$5.5 million for the six months ended June 30, 2005. The increased charge against written premium is primarily associated with the timing of our reinsurance payments measured against the term of the underlying reinsurance policies.

### (Increase) in Unearned Premiums

The (increase) in unearned premiums was (\$23.2) million for the six months ended June 30, 2006, as compared to (\$10.3) million for the six months ended June 30, 2005. The change was due to a \$22.6 million increase in unearned homeowners' insurance premiums, a \$4.1 million increase in unearned commercial general liability premiums, a \$3.5 million decrease in unearned automobile premiums, and a \$0.1 million decrease in unearned mobile home insurance premiums. These changes reflect our continued growth along our homeowners' and commercial general liability lines of business. For further discussion, see "Unearned Premiums" above.

### Finance Revenue

Finance revenue decreased \$0.9 million, or 44.6%, to \$1.1 million for the six months ended June 30, 2006, as compared to \$2.0 million for the six months ended June 30, 2005. The decrease is primarily due to the sale in December 2004 of our assets related to our non-standard automobile insurance agency business in Florida and the finance revenue derived there from.

### Managing General Agent Fees

Managing general agent fees increased \$0.1 million, or 10.2%, to \$1.4 million for the six months ended June 30, 2006, as compared to \$1.3 million for the six months ended June 30, 2005. The increase is associated with the number of policies issued during the respective periods.

### Net Investment Income

Net investment income increased \$1.0 million, or 55.7%, to \$2.8 million for the six months ended June 30, 2006, as compared to \$1.8 million for the six months ended June 30, 2005. The increase in investment income is primarily a result of the additional amounts of invested assets. Also affecting our net investment income was an increase in overall yield to 4.8% for the six months ended June 30, 2006 as compared to a yield of 4.28% for the six months ending June 30, 2005.

### Net Realized Investment Gains

Net realized investment gains increased \$0.2 million, or 68.2% to \$0.5 million for the six months ended June 30, 2006, as compared to \$0.3 million for the six months ended June 30, 2005. The table below depicts the gains by investment category.

| <b>Net Realized Gains (Losses)</b> |             |
|------------------------------------|-------------|
| <b>Six Months Ended June 30,</b>   |             |
| <b>2006</b>                        | <b>2005</b> |

Fixed maturities:

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|  |    |          |    |           |
|--|----|----------|----|-----------|
| U.S. government obligations and agencies         | \$ | (32,516) | \$ | (131,066) |
| Obligations of states and political subdivisions |    | 75       |    | (43)      |
|  |    | (32,441) |    | (131,109) |
| Corporate securities:                            |    |          |    |           |
| Other  |    | (33,816) |    | 31,521    |
| Equity securities:                               |    |          |    |           |
| Common stocks                                    |    | 545,809  |    | 384,621   |
| Total net realized gains                         | \$ | 479,552  | \$ | 285,033   |

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### Other Income

Other income increased \$0.7 million, or 173.9%, to \$1.1 million for the six months ended June 30, 2006, as compared to \$0.4 million for the six months ended June 30, 2005. Major components of other income for the six months ended June 30, 2006 included approximately \$270,000 in connection with the recognition of our gain on the sale of our Lauderdale Lakes property, \$247,000 of commissions in connection with the acquisition of our current reinsurance program, \$159,000 of commissions in connection with the national flood insurance program, \$153,000 in connection with our business interruption insurance proceeds stemming from Hurricane Wilma and \$119,000 of policy fees in connection with our commercial general liability program.

### Loss and LAE

Loss and LAE, our most significant expense, represent actual payments made and changes in estimated future payments to be made to or on behalf of our policyholders, including expenses required to settle claims and losses. We revise our estimates based on the results of analysis of estimated future payments to be made. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for predicting future events

Loss and LAE decreased by \$2.3 million, or 12.0%, to \$16.9 million for the six months ended June 30, 2006, as compared to \$19.2 million for the six months ended June 30, 2005. The decrease is attributable to the increase in loss and LAE incurred during the six months ended June 30, 2005 which was in connection with the adverse development associated with the 2004 hurricanes.

We continue to revise our estimates of the ultimate financial impact of past storms. The revisions to our estimates are based on our analysis of subsequent information that we receive regarding various factors, including: (i) per claim information; (ii) company and industry historical loss experience; (iii) legislative enactments, judicial decisions, legal developments in the awarding of damages, and (iv) trends in general economic conditions, including the effects of inflation. Management revises its estimates based on the results of its analysis. This process assumes that past experience, adjusted for the effects of current developments and anticipated trends, is an appropriate basis for estimating the ultimate settlement of all claims. There is no precise method for subsequently evaluating the impact of any specific factor on the adequacy of the reserves, because the eventual redundancy or deficiency is affected by multiple factors.

The table below reflects no effect to operations during the six months ended June 30, 2006 from the four hurricanes that occurred in July, August, September and October of 2005. As to Hurricane Wilma, despite the increase in claim count during the six months ended June 30, 2006, gross losses and reinsurance recoveries have increased by \$8.1 million due primarily to an increase in average severity per claim.

| 2005 Hurricanes            | Claim<br>Count | Gross<br>Losses | Reinsurance<br>Recoveries | Net<br>Losses |
|----------------------------|----------------|-----------------|---------------------------|---------------|
|                            |                |                 | (Dollars in millions)     |               |
| Dennis (July 10)           | -              | \$ -            | \$ -                      | \$ -          |
| Katrina (August 25)        | 20             | -               | -                         | -             |
| Rita (September 20)        | (5)            | -               | -                         | -             |
| Wilma (October 24)         | 1,251          | 8.1             | 8.1                       | -             |
| <b>Total Loss Estimate</b> | 1,266          | \$ 8.1          | \$ 8.1                    | \$ -          |

The following table reflects the changes during the six months ended June 30, 2006 in connection with the four hurricanes that occurred in August and September of 2004. A charge of \$1.2 million occurred during the six months ended June 30, 2006 in connection with these storms.

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| 2004 Hurricanes            | Claim<br>Count | Gross<br>Losses | Reinsurance<br>Recoveries |             | Net<br>Losses |
|----------------------------|----------------|-----------------|---------------------------|-------------|---------------|
|                            |                |                 | (Dollars in millions)     |             |               |
| Charley (August 13)        | 5              | \$ 1.3          | \$ 1.3                    | \$ -        | -             |
| Frances (September 3)      | 3              | 0.5             | 0.5                       | -           | -             |
| Ivan (September 14)        | (4)            | 1.0             | -                         | -           | 1.0           |
| Jeanne (September 25)      | 12             | 0.2             | -                         | -           | 0.2           |
| <b>Total Loss Estimate</b> | <b>16</b>      | <b>\$ 3.0</b>   | <b>\$ 1.8</b>             | <b>\$ -</b> | <b>1.2</b>    |

Our loss ratio, as determined in accordance with GAAP, for the six month period ended June 30, 2006 was 33.46% compared with 47.19% for the same period in 2005. The table below reflects the loss ratios by product line.

|                      | Six months ended June 30, |        |
|----------------------|---------------------------|--------|
|                      | 2006                      | 2005   |
| Automobile           | 82.56%                    | 61.92% |
| Homeowners'          | 26.04%                    | 47.93% |
| Commercial liability | 17.60%                    | 23.04% |
| All lines            | 33.46%                    | 47.19% |

For further discussion, see the Note 7 to the Consolidated Financial Statements included under Part I, Item 1, of this Report.

### Operating and Underwriting Expenses

Operating and underwriting expenses increased \$0.8 million, or 21.7%, to \$4.6 million for the six months ended June 30, 2006, as compared to \$3.8 million for the six months ended June 30, 2005. The change is primarily due to premium tax expense which increased \$0.7 million, or 91.3%, to \$1.5 million for the six months ended June 30, 2006, as compared to \$0.8 million for the six months ended June 30, 2005. Premium tax expense is directly correlated to written premium, which experienced an increase in 2006.

### Salaries and Wages

Salaries and wages increased \$0.5 million, or 14.3%, to \$3.6 million for the six months ended June 30, 2006, as compared to \$3.2 million for the six months ended June 30, 2005. As a result of adopting SFAS No. 123R on January 1, 2006, salaries and wages for the six months ended June 30, 2006 increased \$280,000, representing approximately 62.0% of the 2006 overall increase. The remaining increase in salaries and wages was due in part to the increased labor costs in connection with additional claims loss adjusters added to our staff. We believe that salaries and wages are consistent with retaining quality management and increased premium production.

### Interest Expense

Interest expense decreased \$0.4 million, or 49.3%, to \$0.4 million for the six months ended June 30, 2006, as compared to \$0.8 million for the six months ended June 30, 2005. The change is primarily attributed to our decreased reliance upon outside sources for financing our contracts receivable.

### Policy Acquisition Costs, Net of Amortization

Policy acquisition costs, net of amortization, increased \$1.0 million, or 14.2%, to \$8.0 million for the six months ended June 30, 2006, as compared to \$7.0 million for the six months ended June 30, 2005. Policy acquisition costs, net of amortization, consists of the actual policy acquisition costs, including commissions, payroll and premium taxes, less commissions earned on reinsurance ceded and policy fees earned.

**Provision for Income Tax Expense**

The provision for income tax expense for continuing and discontinued operations increased \$3.7 million, or 69.7%, to \$8.9 million for the six months ended June 30, 2006, as compared to \$5.3 million for the six months ended June 30, 2005. The effective rate for income tax expense is 37.5% for the six months ended June 30, 2006, as compared to 37.4% for the same six month period in 2005.

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As a result of the foregoing, the Company's net income for the six months ended June 30, 2006 was \$14.9 million compared to net income of \$8.8 million for the six months ended June 30, 2005.

### Liquidity and Capital Resources

For the six months ended June 30, 2006, our primary sources of capital were revenues generated from operations, including decreased amounts due from reinsurers, net, increased unearned premiums, decreased prepaid reinsurance premiums and increased income taxes payable. Additionally, operational sources of capital came from decreased finance contracts receivable, decreased other assets, increased accounts payable and accrued expenses, increased premium deposits, net realized investment gains, non-cash compensation, depreciation and amortization, common stock issued for interest on notes, an increase in the provision for credit losses and increased funds held under reinsurance treaties. Also contributing to our liquidity were proceeds from exercised warrants, the sale of assets, exercised employee stock options, and a tax benefit related to non-cash compensation. Because we are a holding company, we are largely dependent upon fees and commissions from our subsidiaries for cash flow.

For the six months ended June 30, 2006, operations provided net operating cash flow of \$49.3 million, as compared to \$13.9 million for the six months ended June 30, 2005.

For the six months ended June 30, 2006, operations generated \$181.9 million of gross cash flow, due to a \$120.5 million decrease in amounts due from reinsurers, net, a \$23.2 million increase in unearned premiums, a \$9.3 million decrease in prepaid reinsurance premiums, a \$4.7 million increase in income taxes payable, a \$3.5 million decrease in finance contracts receivable, a \$1.9 million decrease in other assets, a \$1.5 million increase in accounts payable and accrued expenses and a \$1.3 million increase in premium deposits. To a much less significant extent, operations generated additional sources of cash via \$0.5 million of net realized investment gains, \$0.3 million of non-cash compensation, \$0.2 million in depreciation and amortization, \$0.1 million of common stock issued for interest on notes and a \$0.1 million increase in the provision for credit losses; all in conjunction with net income of \$14.9 million.

For the six months ended June 30, 2006, operations used \$132.6 million of gross cash flow primarily due to a \$122.7 million decrease in unpaid losses and LAE, a \$2.8 million increase in policy acquisition costs, net of amortization, and a \$2.7 million increase in premiums receivable, a \$2.3 million increase in deferred income tax expense, a \$1.9 million decrease in bank overdrafts, \$0.1 million in amortization of investment discount, net, and a \$0.1 million decrease in the provision for uncollectible premiums receivable.

Subject to catastrophic occurrences, net operating cash flow is currently expected to be positive in both the short-term and the reasonably foreseeable future.

For the six months ended June 30, 2006, net investing activities used \$48.9 million, as compared to providing \$1.7 million for the six months ended June 30, 2005. Our available for sale investment portfolio is highly liquid as it consists entirely of readily marketable securities.

For the six months ended June 30, 2006, investing activities generated \$192.2 million and used \$226.5 million from the maturity several times over of our very short municipal portfolio. An additional use of cash flow from investing activities was a \$17.0 million receivable for investments sold. Sources of cash flow from investing activities included the sale of property with net book value of \$2.7 million, for which we received \$5.6 million in proceeds and recorded a \$2.9 million deferred gain. The Company also used \$0.4 million for the purchase of equipment.

For the six months ended June 30, 2006, net financing activities provided \$3.5 million, as compared to using \$3.1 million for the six months ended June 30, 2005. For the six months ended June 30, 2006, the sources of cash in connection with financing activities included \$6.1 million from the exercise of warrants, a \$1.7 million tax benefit related to non-cash compensation and \$1.4 million from the exercise of stock options. The uses of cash in connection with financing activities included \$2.0 million for the acquisition of common stock, \$1.9 million in dividends paid, \$1.7 million for the regularly scheduled principal and interest payments on our Notes and \$0.2 million in connection with the reduction of our outstanding revolving credit.

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Federated Premium's operations are partially funded by the revolving loan agreement with FlatIron. The effective interest rate on this line of credit, based on our average outstanding borrowings under the Revolving Agreement, was 14.40% and 9.39% for the six months ended June 30, 2006 and 2005, respectively. Interest expense on this revolving credit line totaled approximately \$7,100 and \$64,200 for the six months ended June 30, 2006 and 2005, respectively.

Outstanding borrowings under the Revolving Agreement were nothing and approximately \$200,000 as of June 30, 2006 and December 31, 2005, respectively.

As an alternative to premium finance, we offer direct billing in connection with our automobile program, where the insurance company accepts from the insured, as a receivable, a promise to pay the premium, as opposed to requiring the full amount of the policy, either directly from the insured or from a premium finance company. The advantage of direct billing a policyholder by the insurance company is that we are not reliant on our credit facility, but remain able to charge and collect interest from the policyholder.

We believe that our current capital resources, together with cash flow from operations, will be sufficient to meet currently anticipated working capital requirements. There can be no assurances, however, that such will be the case.

Federated National's and American Vehicle's statutory capital surplus levels as of June 30, 2006 were approximately \$22.3 million and \$23.0 million, respectively, and their statutory net income for the six months ended June 30, 2006 were \$9.9 million and \$3.1 million, respectively.

As of June 30, 2006, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as "structured finance" or "special purpose" entities, which were established for the purpose of facilitating off-balance-sheet arrangements or other contractually narrow or limited purposes. As such, management believes that we currently are not exposed to any financing, liquidity, market or credit risks that could arise if we had engaged in transactions of that type requiring disclosure herein.

### **Impact of Inflation and Changing Prices**

The consolidated financial statements and related data presented herein have been prepared in accordance with GAAP, which requires the measurement of financial position and operating results in terms of historical dollars without considering changes in the relative purchasing power of money over time due to inflation. The primary assets and liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or with the same magnitude as the inflationary effect on the cost of paying losses and LAE.

Insurance premiums are established before the Company knows the amount of loss and LAE and the extent to which inflation may affect such expenses. Consequently, we attempt to anticipate the future impact of inflation when establishing rate levels. While we attempt to charge adequate premiums, we may be limited in raising our premium levels for competitive and regulatory reasons. Inflation also affects the market value of our investment portfolio and the investment rate of return. Any future economic changes which result in prolonged and increased levels of inflation could cause increases in the dollar amount of incurred loss and LAE and thereby materially adversely affect future liability requirements.

### **Item 3**

#### **Quantitative and Qualitative Disclosures about Market Risk**

Information related to quantitative and qualitative disclosures about market risk was included under Item 7a, “Quantitative and Qualitative Disclosures about Market Risk”, in our Annual Report on Form 10-K for the year ended December 31, 2005. No material changes have occurred in market risk since this information was disclosed except as discussed below.

Our investment portfolio is available for sale and is carried at fair value, except for that portion deemed as held to maturity. Gains that represent securities with a fair value in excess of amortized cost, and losses (amortized cost is in excess of fair value) that are deemed temporary by management are recorded in shareholders’ equity in accumulated other comprehensive income. Losses that are deemed other than temporary by management are recorded as net realized losses in the consolidated statement of operations. A summary of the investment portfolio as of June 30, 2006 follows:

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|  | Amortized Cost |         | Fair Value     |         | Unrealized Gain (Loss) |
|--|----------------|---------|----------------|---------|------------------------|
| Fixed maturities:                                |                |         |                |         |                        |
| U.S. government obligations and agencies         | \$ 69,361,984  | 59.34%  | \$ 68,051,017  | 59.66%  | \$ (1,310,967)         |
| Obligations of states and political subdivisions | 17,589,373     | 15.04%  | 17,261,187     | 15.12%  | (328,186)              |
|  | 86,951,357     | 74.38%  | 85,312,204     | 74.78%  | (1,639,153)            |
| Corporate securities:                            |                |         |                |         |                        |
| Communications                                   | 256,924        | 0.22%   | 260,325        | 0.22%   | 3,401                  |
| Financial  | 2,000,000      | 1.71%   | 1,918,335      | 1.69%   | (81,665)               |
| Other  | 11,907,451     | 10.19%  | 11,886,559     | 10.42%  | (20,892)               |
|  | 14,164,375     | 12.12%  | 14,065,219     | 12.33%  | (99,156)               |
| Equity securities:                               |                |         |                |         |                        |
| Common stocks                                    | 15,779,144     | 13.50%  | 14,699,165     | 12.89%  | (1,079,979)            |
|  | 15,779,144     | 13.50%  | 14,699,165     | 12.89%  | (1,079,979)            |
| Total fixed, corporate and equity securities     | \$ 116,894,876 | 100.00% | \$ 114,076,588 | 100.00% | \$ (2,818,288)         |

As of June 30, 2006, there were no concentrations greater than 5% of total investments in any single investment other than United States government obligations.

#### Item 4

##### Controls and Procedures

**Evaluation of Disclosure Controls and Procedures** An evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures was carried out as of June 30, 2006 by the Company under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures have been designed and are being operated in a manner that provides reasonable assurance that the information required to be disclosed by the Company in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Nevertheless, the controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

**Changes in Internal Controls** Subsequent to the date of the most recent evaluation of the Company's internal controls, there were no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

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### Part II: OTHER INFORMATION

#### Item 1

##### Legal Proceedings

We are involved in various claims and legal actions arising in the ordinary course of business. Specifically, we are a party to approximately fifteen lawsuits in connection with coverage disputes associated with claims resulting from Hurricanes Ivan and Jeanne. Hurricane Ivan occurred on September 14, 2004. Hurricane Jeanne occurred on September 25, 2004.

The outcome of the pending litigation in connection with these cases remains unclear but could have a significant negative impact on current operations once additional uncertainties become a matter of fact. These uncertainties involve the outcome of other cases involving similarly styled coverage issues involving other property insurers in various stages of discovery. Due to these uncertainties management recognizes the potentially negative outcome of this pending litigation is reasonably possible, but the ultimate financial impact is currently undeterminable.

In 2000 and 2001 respectively, two class action lawsuits were filed against an unaffiliated insurance company for which our subsidiary, Assurance MGA, was the managing general agent. These lawsuits were seeking compensatory damages in an undisclosed amount based on allegations of unfair practices involving the computation of interest due the policyholder in connection with automobile premium refunds. The unaffiliated company has contested these lawsuits over the last several years. Negotiations relative to this matter have been ongoing and in July 2005 the parties reached an agreement wherein we have paid \$240,000 to resolve the underlying actions in these suits subject to our contractual duties with respect to the unaffiliated company. We believe that we will be successful in our efforts to enjoin others to participate in this settlement; however we are unable to quantify the participation of others at this time. Accordingly, we charged against second quarter 2005 earnings \$240,000 for this action.

In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial position, results of operations, or liquidity.

#### Item 1A

##### Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results. The most significant of these risks include weather related conditions.

#### Item 2

##### (a) Unregistered Sales of Equity Securities and Use of Proceeds

During the six months ended June 30, 2006, nine warrant holders exercised their warrants to acquire an aggregate of 475,330 shares of our common stock. The exercise price of the Warrants was approximately \$18.70 per share. The

names of the warrant holders, dates of exercise, number of shares purchased, exercise price and proceeds received by us are listed below.

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| Name  | Date of Grant      | Date of Exercise | Number of Shares | Exercise Price | Proceeds Received |
|---|--------------------|------------------|------------------|----------------|-------------------|
| WhiteBox Convertible Arbitrage Partners, LP | September 30, 2004 | January 27, 2006 | 224,619          | 12.750         | 2,863,892         |
| Omega Overseas Partners Ltd.                | July 31, 2003      | January 20, 2006 | 82,500           | 12.744         | 1,051,380         |
| Hillson Partners LP                         | September 30, 2004 | January 25, 2006 | 78,431           | 12.750         | 999,995           |
| Pandora Select Partners, LP                 | September 30, 2004 | January 27, 2006 | 45,131           | 12.750         | 575,420           |
| Whitebox Intermarket Partners LP            | September 30, 2004 | January 27, 2006 | 33,824           | 12.750         | 431,256           |
| Chris Pellegrini                            | July 31, 2003      | January 20, 2006 | 2,250            | 12.744         | 28,674            |
| WhiteBox Convertible Arbitrage Partners, LP | September 30, 2004 | January 18, 2006 | 1,000            | 12.750         | 12,750            |
| Cedric Fricke                               | July 31, 2003      | May 17, 2006     | 1,500            | 12.744         | 19,116            |
| Cedric Fricke                               | July 31, 2003      | June 12, 2006    | 6,000            | 12.744         | 76,464            |
| Young & Usha Ganju                          | July 31, 2003      | June 16, 2006    | 75               | 12.744         | 956               |

Each of the warrant holders paid for their shares with cash. Each of these warrant holders exercised their warrants in reliance upon Section 4(2) of the Securities Act of 1933, because each of these holders was knowledgeable, sophisticated and had access to comprehensive information about us. We placed legends on the certificates stating that the securities were not registered under the Securities Act and set forth the restrictions on their transferability and sale.

During the six months ended June 30, 2006, thirty-seven persons exercised options to acquire an aggregate of 181,600 shares of the Company's common stock with proceeds to the Company aggregating to approximately \$3.2 million. The individuals exercising options consists of thirty-two employees, the Chief Executive Officer and his wife, the former Chief Operating Officer of the Company and two franchise owners. All of the option holders paid cash for these shares. The shares underlying the options were registered on registration statements on Form S-8 and the shares issued to these persons do not contain any restrictive legends.

**(b) None**

**(c) Market for the Company's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

On May 16, 2006, the Company's Board of Directors authorized, pursuant to Section 12 of the Securities Exchange Act, the repurchase of up to \$2.0 million of its common stock. Acting upon the Board's authorization, the Company repurchased, for approximately \$2.0 million, 130,461 shares for an average price of \$15.34 between May 16, 2006 and May 24, 2006. The table below provides, in tabular format, information about our purchase of equity securities that are registered by the Company.

| <b>Period</b> | <b>Total Number<br/>of Shares<br/>Purchased</b> | <b>Average Price<br/>Paid per Share</b> | <b>Total Number<br/>of Shares<br/>Purchased as<br/>Part of Publicly<br/>Announced<br/>Plans or<br/>Programs</b> | <b>Maximum<br/>Number of<br/>Shares that<br/>May Yet Be<br/>Purchased<br/>Under the Plan</b> |
|---------------|---|---|---|--|
| April-06      | None  | None                                    | None  | None   |
| May-06        | \$ 130,461                                      | \$ 15.34                                | \$ 130,461  | None   |
| June-06       | None  | None                                    | None  | None   |

**Item 3****Defaults upon Senior Securities**

None

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### Item 4

#### Submission of Matters to a Vote of Security Holders

Our annual meeting of shareholders was held on June 6, 2006. Proxies for the meeting were solicited pursuant to Regulation 14A of the Securities Exchange Act of 1934 and there was no solicitation in opposition to that of management.

All of management's nominees for directors as listed in the proxy statement were elected. Bruce Simberg, Richard W. Wilcox, Jr. and Peter J. Prygelski were elected as Class II directors to serve until the Annual Shareholder's Meeting to be held in 2009 or until their successors are elected and qualified. The number of votes cast for each nominee is as follows:

|                        | Shares Voted<br>"FOR" | Votes<br>Withheld |
|------------------------|-----------------------|-------------------|
| Bruce Simberg          | 5,543,937             | 84,127            |
| Richard W. Wilcox, Jr. | 5,540,744             | 87,310            |
| Peter J. Prygelski     | 5,544,319             | 83,735            |

The proposal to approve the appointment of DeMeo Young McGrath as the Company's independent auditors for the fiscal year ended December 31, 2006, was ratified by the following votes:

| Shares Voted<br>"FOR" | Shares Voted<br>"AGAINST" | Shares<br>"ABSTAINING" | Broker<br>"NON-VOTE" |
|-----------------------|---------------------------|------------------------|----------------------|
| 5,594,858             | 27,160                    | 6,036                  | 0                    |

### Item 5

#### Other Information

None

### Item 6

#### Exhibits

10.1 American Vehicle Insurance Company 100% Quota Share Reinsurance Agreement with Republic Underwriters Insurance Company for a portion of its business and a portion of the business assumed by it from its affiliated member companies executed on April 15, 2006 and became effective April 15, 2006 (incorporated by reference to Exhibit 10.37 in the Company's current report Form 8-K held with the Securities and Exchange Commission ("SEC") on April 19, 2006).

10.2 Reimbursement Contract between Federated National Insurance Company and The State Board of Administration of Florida (SBA) which administers the Florida Hurricane Catastrophe Fund (FHCF), effective June 1, 2006 (incorporated by reference to Exhibit 10.38 in the Company's current report on Form 8-K held with the SEC on June 2, 2006).



10.39 Addendum No. 1 to the Reimbursement Contract between Federated National Insurance Company and The State Board of Administration of Florida (SBA) which administers the Florida Hurricane Catastrophe Fund (FHCF), effective June 1, 2006 (incorporated by reference to Exhibit 10.39 in the Company's current report on Form 8-K held with the SEC on June 2, 2006).

10.4 Addendum No. 2 to the Reimbursement Contract between Federated National Insurance Company and The State Board of Administration of Florida (SBA) which administers the Florida Hurricane Catastrophe Fund (FHCF), effective June 1, 2006 (incorporated by reference to Exhibit 10.40 in the Company's current report on Form 8-K held with the SEC on June 2, 2006).

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- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act. \*
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act. \*
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act. \*
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act. \*

\* filed herewith

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**21<sup>st</sup> Century Holding Company**

**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 hereunto duly authorized.

**21<sup>st</sup> CENTURY HOLDING COMPANY**

By: */s/ Edward J. Lawson*

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Edward J. Lawson, President, Chief Executive Officer and  
Chairman of the Board

*/s/ James G. Jennings, III*

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James G. Jennings III, Chief Financial Officer

Date: August 11, 2006