

Section 1: 10-K (ANNUAL REPORT PURSUANT TO SECTION 13 AND 15(D))

[Table of Contents](#)

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

(Mark One)

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

For the fiscal year ended December 31, 2010

OR

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

Commission File Number 1-31987

**Hilltop Holdings Inc.**

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

200 Crescent Court, Suite 1330  
Dallas, Texas

(Address of principal executive offices)

84-1477939

(I.R.S. Employer Identification No.)

75201

(zip code)

(214) 855-2177

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$0.01 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting

company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the common stock of the registrant held by non-affiliates of the registrant, computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2010, was approximately \$398 million. For purposes of this computation, all officers, directors and 10% stockholders were deemed to be affiliates. This determination should not be construed as an admission that such officers, directors and 10% stockholders are affiliates. The number of shares of the registrant’s common stock outstanding at March 11, 2011 was 56,496,619.

## DOCUMENTS INCORPORATED BY REFERENCE

The Registrant’s definitive Proxy Statement pertaining to the 2011 Annual Meeting of Stockholders, filed or to be filed not later than 120 days after the end of the fiscal year pursuant to Regulation 14A, is incorporated herein by reference into Part III.

### [Table of Contents](#)

#### Table of Contents

<u>Item</u>	<u>Description</u>	<u>Page</u>
<b><u>PART I</u></b>		
<u>1.</u>	<u>Business</u>	2
<u>1A.</u>	<u>Risk Factors</u>	22
<u>1B.</u>	<u>Unresolved Staff Comments</u>	38
<u>2.</u>	<u>Properties</u>	38
<u>3.</u>	<u>Legal Proceedings</u>	38
<u>4.</u>	<u>Reserved</u>	38
<b><u>PART II</u></b>		
<u>5.</u>	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	39
<u>6.</u>	<u>Selected Financial Data</u>	41
<u>7.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operation</u>	42
<u>7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	61
<u>8.</u>	<u>Financial Statements and Supplementary Data</u>	61
<u>9.</u>	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	61
<u>9A.</u>	<u>Controls and Procedures</u>	61
<u>9B.</u>	<u>Other Information</u>	62
<b><u>PART III</u></b>		
<u>10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	62
<u>11.</u>	<u>Executive Compensation</u>	62
<u>12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	62
<u>13.</u>	<u>Certain Relationships and Related Transactions and Director Independence</u>	63
<u>14.</u>	<u>Principal Accounting Fees and Services</u>	63
<b><u>PART IV</u></b>		
<u>15.</u>	<u>Exhibits and Financial Statement Schedules</u>	64

## MARKET AND INDUSTRY DATA AND FORECASTS

Market and industry data and other statistical information and forecasts used throughout this Annual Report on Form 10-K are based on independent industry publications, government publications and reports by market research firms or other published independent sources. We have not sought or obtained the approval or endorsement of the use of this third-party information. Some data also is based on our good faith estimates, which are derived from our review of internal surveys, as well as independent sources. Forecasts are particularly likely to be inaccurate, especially over long periods of time.

### [Table of Contents](#)

*Unless the context otherwise indicates, all references in this Annual Report on Form 10-K to the “Company,” “Hilltop,” “HTH,” “we,” “us,” “our” or “ours” or similar words are to Hilltop Holdings Inc.(formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.*

## FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K and the documents incorporated by reference into this report include “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, or

Exchange Act, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, included in this Annual Report on Form 10-K that address results or developments that we expect or anticipate will or may occur in the future, where statements are preceded by, followed by or include the words “believes,” “expects,” “may,” “will,” “would,” “could,” “should,” “seeks,” “approximately,” “intends,” “plans,” “projects,” “estimates” or “anticipates” or the negative of these words and phrases or similar words or phrases, including such things as our business strategy, our financial condition, our litigation, our efforts to make strategic acquisitions, our liquidity and sources of funding, our capital expenditures, our products, market trends, operations and business, are forward-looking statements.

These forward-looking statements are based on our beliefs, assumptions and expectations of our future performance taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If an event occurs or further changes, our business, business plan, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Certain factors that could cause actual results to differ include, among others:

- changes in the acquisition market;
- our ability to find and complete strategic acquisitions with suitable merger or acquisition candidates or find other suitable ways in which to invest our capital;
- the adverse impact of external factors, such as changes in interest rates, inflation and consumer confidence;
- the condition of capital markets;
- actual outcome of the resolution of any conflict;
- our ability to use net operating loss carryforwards to reduce future tax payments;
- the impact of the tax code and rules on our financial statements;
- failure of NLASCO, Inc.’s insurance subsidiaries to maintain their respective A.M. Best ratings;
- failure to maintain NLASCO, Inc.’s current agents;
- lack of demand for insurance products;
- cost or availability of adequate reinsurance;
- changes in key management;
- severe catastrophic events in our geographic area;
- failure of NLASCO, Inc.’s reinsurers to pay obligations under reinsurance contracts;
- failure of NLASCO, Inc. to maintain sufficient reserves for losses on insurance policies;
- failure to successfully implement NLASCO, Inc.’s new information technology system; and
- failure of NLASCO, Inc. to maintain appropriate insurance licenses.

For a further discussion of these and other risks and uncertainties that could cause actual results to differ materially from those contained in our forward-looking statements, please refer to “Risk Factors” in this report. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements, and there can be no assurance that the actual results or developments anticipated by us will be realized, or even substantially realized, and that they will have the expected consequences to, or effects on, us and our business or operations. Forward-looking statements made in this report speak as of the date of this report or as of the date specifically referenced in any such statement set forth in this report. We undertake no obligation to update or revise any forward-looking statements in this report.

---

## [Table of Contents](#)

### **PART I**

#### **ITEM 1. BUSINESS**

##### **General Information**

We are a holding company that is endeavoring to make opportunistic acquisitions or effect a business combination. In connection with that strategy, we are identifying and evaluating potential targets across all industries on an ongoing basis. At December 31, 2010, we had approximately \$600 million aggregate available cash and cash equivalents that may be used for this purpose. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or effect a combination or, if consummated, successfully integrate or operate the acquired business.

The Company originally received its shelf charter in November 2008. Given the amount of time elapsed since the original application and various other changes, the Office of the Comptroller of the Currency requested that a full, updated application be re-filed. Accordingly, the Company withdrew the original shelf charter application and re-filed an application that reflects updates and other changes made since the original application. No assurances, however, can be given that the regulatory authorities will grant the shelf charter.

We also provide fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States through our wholly-owned property and casualty insurance holding company, NLASCO, Inc., or NLASCO. We acquired NLASCO in January 2007. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company, (“NLIC”), and American Summit Insurance Company, (“ASIC”).

NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and

policyholders. NLASCO applies a high level of selectivity in the risks it underwrites and uses a risk-adjusted return approach to capital allocation, which NLASCO believes allows it to consistently generate underwriting profits.

NLIC and ASIC carry a financial strength rating of “A” (Excellent) by A.M. Best. An “A” rating is the third highest of 16 rating categories used by A.M. Best. Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. This rating is intended to provide an independent opinion of an insurer’s ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best’s expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and loss adjustment expenses, and is subject to revocation or revision at any time at the sole discretion of A.M. Best.

Our common stock is listed on the New York Stock Exchange, or NYSE, under the symbol “HTH.”

Our principal office is located at 200 Crescent Court, Suite 1330, Dallas, Texas 75201, and our telephone number at that location is (214) 855-2177. Our internet address is [www.hilltop-holdings.com](http://www.hilltop-holdings.com).

We currently are subject to the reporting requirements of the Exchange Act and, therefore, file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission, or the SEC. These filings, and amendments to these filings, may be accessed, free of charge, on the investor relations page of our website as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. Additionally, any materials that we file with, or furnish to, the SEC may be read and copied at the SEC’s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for more information regarding the operations of the SEC Public Reference Room. The SEC also maintains a website, [www.sec.gov](http://www.sec.gov), which contains reports, proxy and information statements and other information regarding issuers, such as ourselves, that file electronically with the SEC. Our codes of conduct and ethics, including amendments to, and waivers of, those codes, our corporate governance guidelines, director independence criteria and board committee charters can be accessed, free of charge, on our website, as well. We will provide, at no cost, a copy of these documents upon request by telephone or in writing at the above phone number or address, attention: Investor Relations. The references to our website address do not constitute incorporation by reference of the information contained on our website into, and should not be considered a part of, this Annual Report on Form 10-K.

---

## [Table of Contents](#)

In 2010, our Chief Executive Officer certified to the NYSE, pursuant to Section 303A.12 of the NYSE’s listing standards, and that he is unaware of any violation by us of the NYSE’s corporate governance listing standards.

## **Company Background**

We were formed in 1998 under the name “Affordable Residential Communities Inc.” as a Maryland corporation that elected to be taxed as a real estate investment trust, or REIT. Until July 2007, we primarily engaged in the acquisition, renovation, repositioning and operation of all-age manufactured home communities, the retail sale and financing of manufactured homes, the rental of manufactured homes and other related businesses, including acting as agent in the sale of homeowners’ insurance and related products, to residents and prospective residents of those communities. Our primary operations previously were conducted through an operating partnership, in which we owned a general partnership interest.

On February 18, 2004, we completed our initial public offering, or IPO. Through the year ended December 31, 2005, we operated as a fully integrated, self-administered and self-managed equity REIT for U.S. federal income tax purposes. In 2006, we revoked our election as a REIT for U.S. federal income tax purposes.

In January 2007, we acquired NLASCO. NLASCO was incorporated in Delaware in 2000, but its origins trace back to 1948 through one of its subsidiaries, NLIC.

On July 31, 2007, we sold substantially all of the operating assets used in our manufactured home communities business and our retail sales and financing business to American Residential Communities LLC. We intend to make opportunistic acquisitions with certain of the remaining proceeds from this transaction and, if necessary or appropriate, from additional equity or debt financing sources. In conjunction with this transaction, we transferred to the buyer the rights to the “Affordable Residential Communities” name, changed our name to Hilltop Holdings Inc., and moved our headquarters to Dallas, Texas.

Following the completion of the sale of our manufactured home communities businesses, our current operations have consisted solely of those of NLASCO and its subsidiaries. Therefore, the remainder of our discussion focuses on the property and casualty insurance operations of NLASCO and its subsidiaries.

## **Insurance Operations**

NLASCO specializes in providing fire and limited homeowners insurance for low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO targets underserved markets that require underwriting expertise that many larger carriers have been unwilling to develop given the relatively small volume of premiums produced by local agents. Within these markets, NLASCO attempts to capitalize on its superior local knowledge to identify profitable underwriting opportunities. NLASCO believes that it distinguishes itself from competitors by delivering products that are not provided by many larger carriers, providing a high level of customer service and responding quickly to the needs of its agents and policyholders. NLASCO applies a high level of selectivity in the risks it underwrites and uses a risk-adjusted return approach to capital allocation, which NLASCO believes allows it to consistently generate underwriting profits.

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. Both NLIC and ASIC carry a financial strength rating of "A" (Excellent) by A.M. Best.

## The Insurance Industry

The property and casualty insurance industry provides protection from pre-specified loss events, such as damage to property or liability claims by third parties. Property and casualty insurance can be broadly classified into two lines; personal lines, in which insurance is provided to individuals, and commercial lines, in which insurance is provided to business enterprises. In the U.S., personal and commercial insurance products are written in admitted and non-admitted markets, also known as the excess and surplus lines market. NLASCO provides insurance products in the personal line and the commercial line markets.

## [Table of Contents](#)

In the admitted market, insurers are authorized by state insurance departments to do business, insurance rates and forms are generally highly regulated and coverage tends to be standardized. Within the admitted market, NLASCO focuses on underserved segments that do not fit into the standard underwriting criteria of national insurance companies due to several factors, such as type of business, location and the amount of premium per policy. This portion of the market tends to have limited competition. Therefore, NLASCO believes it has greater flexibility in pricing and product design relative to most admitted market risks.

The non-admitted market focuses on harder-to-place risks that admitted insurers typically do not write. In this market, risks are underwritten with more flexible policy forms and rates, resulting in more restrictive and expensive coverage. NLASCO writes in this market for its dwelling fire, homeowner, and mobile home business in Louisiana.

The property and casualty insurance industry, historically, has been subject to cyclical fluctuations in pricing and availability of insurance coverage. "Soft" markets are often characterized by excess underwriting capital and involve intense price competition, erosion of underwriting discipline and poor operating performance. These market conditions usually lead to a period of diminished underwriting capacity after insurance companies exit unprofitable lines and exhibit greater underwriting discipline and increase premium rates. This latter market condition is called a "hard" market. The insurance market may not always be hard or soft; rather, it could be hard for one line of business and soft for another. The market at the start of 2011 is likely to be characterized as soft for property risks in NLASCO's operating area; however, in coastal areas, due to the hurricane activity in recent years, those markets are considered hard.

## Product Lines

### *Personal and Commercial Lines*

The NLASCO companies specialize in writing fire and homeowners insurance coverage for low value dwellings and manufactured homes. The vast majority of NLASCO's property coverage is written on policies that provide actual cash value payments, as opposed to replacement cost. Under actual cash value policies, the insured is entitled to receive only the cost of replacing or repairing damaged or destroyed property with comparable new property, less depreciation. Additionally, most of NLASCO's property policies exclude coverage for water and mold damage.

In 2010, NLASCO expanded its homeowners insurance products to include replacement cost coverage, which also includes limited water coverage. These new products are being marketed and sold in various states; however, the primary market is Texas. The development and implementation of these new products has contributed to the premium growth at NLASCO in 2010.

NLASCO's business is conducted with two product lines, its personal lines and its commercial lines. The personal lines include homeowners, dwelling fire, manufactured home, flood and vacant policies. The commercial lines include commercial, builders risk, builders risk renovation, sports liability and inland marine policies.

## [Table of Contents](#)

Set forth below is certain financial data broken down by line of business (in millions):

	For The Year Ended December 31,		
	2010	2009	2008
<b>Gross Premiums Written</b>			
Personal lines	\$ 136.5	\$ 129.5	\$ 131.8
Commercial lines	7.9	6.7	6.2
Total	\$ 144.4	\$ 136.2	\$ 138.0
<b>Net Operating income</b>			
Personal lines	\$ 4.9	\$ 5.9	\$ (3.1)
Commercial lines	2.3	0.8	0.5
Total	\$ 7.2	\$ 6.7	\$ (2.6)

<b>Total Assets</b>			
Personal lines	\$	297.5	\$ 247.6
Commerical lines		27.4	22.8
Total	\$	324.9	\$ 270.4

## Geographic Markets

The following table sets forth NLASCO's total gross written premiums by state for the periods shown (in millions):

	<b>For The Year Ended December 31,</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
<b>Gross Written Premiums</b>			
Texas - Flood	\$ 5.9	\$ 5.9	\$ 5.3
Texas - North	26.2	20.7	21.2
Texas - South	29.6	34.4	34.9
Texas - Central	9.6	9.4	9.4
Texas - West	15.5	13.0	13.5
Texas - Panhandle	7.1	6.8	7.3
Texas - East	14.1	13.4	13.2
Texas - Total	108.0	103.7	104.8
Arizona	11.3	11.3	11.8
Tennessee	8.6	7.8	8.0
Oklahoma	6.8	5.1	5.2
Georgia	3.3	1.6	1.1
Louisiana	3.0	3.0	3.0
Missouri	1.2	1.4	1.6
Nevada	1.0	1.1	1.2
All other states	1.2	1.2	1.3
<b>TOTAL</b>	<b>\$ 144.4</b>	<b>\$ 136.2</b>	<b>\$ 138.0</b>

NLASCO underwrites insurance coverage primarily in Texas, as well as other states in the south and southwest regions.

## [Table of Contents](#)

### Distribution

NLASCO distributes its insurance products through a broad network of independent agents in 23 states and a select number of managing general agents, referred to as MGAs. NLASCO has a preference for doing business with agents that desire a long-term relationship that will result in mutual profitability and value for both parties. NLASCO believes that "relationship" agents are more oriented to the long-term and desire a meaningful relationship with their customers and the insurers they represent. NLASCO's top ten agents accounted for only 9.9%, 9.9% and 10.1% of direct premiums written in 2010, 2009 and 2008, respectively, and as of December 31, 2010, the average tenure of the top 25 agencies was over 12 years.

### Underwriting and Pricing

NLASCO applies its regional expertise, underwriting discipline and a risk-adjusted, return-on-equity based approach to capital allocation to primarily offer short-tail insurance products in its target markets. NLASCO's underwriting process involves securing an adequate level of underwriting information from its independent agents, identifying and evaluating risk exposures and then pricing the risks it chooses to accept.

NLASCO employs a disciplined underwriting approach that incorporates the continuously refined stratification of its target markets to permit it to tailor its policies to individual risks and adopt pricing structures that will be supported in the applicable market. NLASCO utilizes underwriting principles and processes that reflect the knowledge and experience it has acquired during its 40-plus year history of underwriting risks. NLASCO believes that this comprehensive process capitalizes on its knowledge and expertise and results in better underwriting decisions.

Pricing levels are established by NLASCO's senior management with the assistance of a consulting actuary. Pricing balances NLASCO's return requirements along with the legal/regulatory environment in each particular geographic region. Management reviews pricing on a quarterly basis to monitor any emerging issues, such as the mold crisis that hit Texas in 2003. NLASCO's statistical database allows this analysis to be performed on a specific coverage or geographic territory. In 2010, ASIC increased premium rates in Arizona and Louisiana and NLIC increased rates in Georgia, Oklahoma, Texas and Tennessee.

### Catastrophe Exposure

NLASCO maintains a comprehensive risk management strategy, which includes actively monitoring its catastrophe prone territories by zip



code to ensure a diversified book of risks. NLASCO utilizes software and risk support from its reinsurance brokers to analyze its portfolio and catastrophe exposure. Biannually, NLASCO has its entire portfolio analyzed by its reinsurance broker who utilizes hurricane models to predict risk. Based on this information and management's active role in risk management, NLASCO makes decisions on what geographic areas to write risks. Over the years, NLASCO has adjusted its business based on its perceived risk of catastrophe losses. For example, in 2005, ASIC withdrew from the Mississippi market to mitigate its catastrophe exposure in that area, and in 2006, it stopped writing new policies that cover wind damage along the seacoast of Louisiana. In 2009, NLASCO decided not to renew wind policies for properties within the Texas seacoast. All policies in catastrophe prone areas will exclude wind by the end of February 2011.

In recent years, NLASCO's catastrophe exposure primarily resulted from property policies in Cameron, Harris, Jefferson and Nueces Counties in Texas, which include the densely populated Houston metropolitan area and the cities extending from the northern tip to the southern point on the Texas Gulf Coast. All of this territory is exposed to potential wind storm activity from the Gulf of Mexico. By not renewing wind policies on the Texas seacoast, which is exposed to the majority of potential wind storm activity, NLASCO's primary catastrophe exposure will be limited to property policies in Harris County. NLASCO also is exposed to hail and other catastrophic events in the Texas panhandle and plains states.

In 2010, the coastal area represented 12% of Texas state-wide premiums; however, less than 1% of these coastal policies included full wind coverage. The panhandle represents 7% of Texas state-wide premiums.

---

## [Table of Contents](#)

### **Terrorism Risk Insurance Act of 2002, Terrorism Risk Insurance Extension Act of 2005 and Terrorism Risk Insurance Program Reauthorization Act of 2007**

On November 26, 2002, the Terrorism Risk Insurance Act of 2002 was enacted into Federal law and established the Terrorism Risk Insurance Program, or the Program. The Program is a Federal program that provides for a system of shared public and private compensation for insured losses resulting from acts of terrorism or war. The Program was scheduled to terminate on December 31, 2005. On December 22, 2005, the Terrorism Risk Insurance Extension Act of 2005 was enacted into Federal law, reauthorizing the Program through December 31, 2007, while reducing the Federal role under the Program. On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act, or the Reauthorization Act, was enacted into Federal law, reauthorizing the Program through December 31, 2014 and implementing several changes to the Program.

In order for a loss to be covered under the Program, as presently constituted, aggregate industry losses of \$100 million must be satisfied. Further, the losses must be the result of an event that is certified as an act of terrorism by the U.S. Secretary of the Treasury, Secretary of State and Attorney General. The original Program excluded from participation certain of the following types of insurance: Federal crop insurance, private mortgage insurance, financial guaranty insurance, medical malpractice insurance, health or life insurance, flood insurance and reinsurance. The 2005 Act exempted from coverage certain additional types of insurance, including commercial automobile, professional liability (other than directors and officers), surety, burglary and theft and farm-owners multi-peril. In the case of a war declared by Congress, only workers' compensation losses are covered by the Program. The Program generally requires that all commercial property and casualty insurers licensed in the United States participate in the Program. Under the Program, a participating insurer is entitled to be reimbursed by the Federal government for a percentage of subject losses, after an insurer deductible, subject to an annual cap. The Federal reimbursement percentage was fixed by the Reauthorization Act at 85%. The deductible is calculated by applying the deductible percentage to the insurer's direct earned premiums for covered lines. The deductible under the Program is fixed at 20%. NLASCO's deductible under the Program was \$1.4 million for 2010 and is estimated to be \$1.6 million in 2011. The annual cap limits the amount of aggregate subject losses for all participating insurers to \$100 billion. Once subject losses have reached \$100 billion aggregate amount during a Program year, there is no additional reimbursement from the U.S. Treasury and an insurer that has met its deductible for the program year is not liable for any losses that exceed the \$100 billion cap. When insured losses under the Program exceed the \$100 billion cap, the insured losses are subject to pro-rata sharing based upon regulations promulgated by the U.S. Treasury. Additionally, under the Reauthorization Act, the timing of mandatory recoupment of the Federal reimbursement through policyholder surcharges was accelerated.

On December 14, 2009, two final rules with respect to the Program were published in the Federal Register. The first rule describes how the Treasury will calculate the amounts to be recouped from insurers and establishes procedures for insurers to use in collecting Federal Terrorism Policy Surcharges and remitting them to the Treasury. The second rule describes how the Treasury intends to determine the pro rata share of insurance losses under the Program when losses otherwise would exceed the annual monetary cap. NLASCO had no terrorism-related losses in 2010.

### **Reinsurance**

NLASCO purchases reinsurance to reduce its exposure to liability on individual risks and claims and to protect against catastrophe losses. NLASCO's management believes that less volatile, yet reasonable returns are in the long-term interest of NLASCO and, as a result, maintains a conservative reinsurance program. NLASCO generated direct premiums written totaling \$138.5 million, net of flood policies, in 2010 and paid approximately \$13.7 million in catastrophe reinsurance premiums prior to any reinstatement premiums.

Reinsurance involves an insurance company transferring, or ceding, a portion of its risk to another insurer, the reinsurer. The reinsurer assumes the exposure in return for a portion of the premium. The ceding of risk to a reinsurer does not legally discharge the primary insurer from its liability for the full amount of the policies on which it obtains reinsurance. Accordingly, the primary insurer remains liable for the entire loss if the reinsurer fails to meet its obligations under the reinsurance agreement, and as a result, the primary insurer is exposed to the risk of non-payment by its reinsurers.

We believe that NLASCO's financial stability is substantially protected from catastrophic events through several excess of loss reinsurance contracts that combine to provide a mix of coverage against various types and combinations of catastrophe losses. As noted in the

section titled “Risk Factors,” NLASCO is exposed to catastrophic losses that could exceed the limits of reinsurance and negatively impact its financial position and results of operations. The Company purchases catastrophe excess of loss reinsurance to a limit that exceeds the Hurricane 500-year return time, as modeled by RMS Risk Link v. 10.0 and AIR v 12.0.

[Table of Contents](#)

In formulating its reinsurance programs, NLASCO believes that it is selective in its choice of reinsurers and considers numerous factors, the most important of which are the financial stability of the reinsurer, its history of responding to claims and its overall reputation. In an effort to minimize exposure to the insolvency of reinsurers, NLASCO evaluates the acceptability, and continuously monitors the financial condition, of each reinsurer. NLASCO enters into reinsurance agreements only with reinsurers that have an A.M. Best financial strength rating of “A- (Excellent)” (fourth highest of 16 categories) or better, or at least an “A” rating by Standard & Poors. If a reinsurer rating subsequently drops below “A- (Excellent),” NLASCO can cancel or replace the reinsurer. As of December 31, 2010, 100% of NLASCO’s paid loss recoverables were from reinsurers rated “A- (Excellent)” or better by A.M. Best. To further minimize exposure to reinsurer insolvency, NLASCO spreads reinsurance treaties among many reinsurers. NLASCO reviews retention levels each year to maintain a balance between the growth in surplus and the cost of reinsurance. NLASCO had no losses from unrecoverable reinsurance in 2010.

NLASCO’s ten largest net receivable balances from reinsurers as of, and for the year ended, December 31, 2010 were as follows (in millions):

	Year Ended December 31, 2010				
	A.M. Best Financial Strength Rating	Ceded Premiums	Balances Due from Reinsurance Companies	Prepaid Reinsurance Premiums	Net Receivable Balance(1)
Federal Emergency Management Agency	N/A	\$ 5.9	\$ 1.1	\$ 4.9	\$ 6.0
Endurance Specialty Insurance Ltd	A	0.3	5.6	—	5.6
Ariel Reinsurance Company Limited	A-	1.3	4.7	—	4.7
Platinum Underwriters Reinsurance, Inc.	A	1.8	4.3	—	4.3
Arch Reinsurance Company	A	1.5	3.0	—	3.0
MS Frontier Reinsurance Limited	A	0.5	2.8	—	2.8
Munich Reinsurance America, Inc.	A+	1.3	2.8	—	2.8
Validus Reinsurance Ltd	A-	0.1	2.0	—	2.0
Amlin Bermuda Limited	A	0.7	1.9	—	1.9
Transatlantic Reinsurance Company	A	0.5	1.5	—	1.5

(1) The net receivable balance includes balances due from reinsurance companies, contingent commissions, prepaid reinsurance premiums and ceded contingent commissions, less balances due to reinsurance companies.

As of December 31, 2010, NLIC had reinsurance for up to \$164 million of losses per event in excess of \$6 million retention by NLIC. This reinsurance is comprised of four layers of protection: \$19 million in excess of \$6 million retention; \$25 million in excess of a \$25 million loss; \$90 million in excess of a \$50 million loss; and \$30 million in excess of a \$140 million loss (the two upper layers also comprise a \$120 million in excess of \$50 million layer). NLIC retains no participation in any of the layers, other than the first \$6 million retention.

As of December 31, 2010, ASIC had reinsurance for up to \$169 million of losses per event in excess of a \$1 million retention by ASIC. This reinsurance is comprised of five layers of protection: \$5 million in excess of \$1 million retention; \$19 million in excess of \$6 million retention; \$25 million in excess of a \$25 million loss; \$90 million in excess of a \$50 million loss; and \$30 million in excess of a \$140 million loss (the two upper layers also comprise a \$120 million in excess of \$50 million layer). ASIC retains no participation in any of the layers, other than the first \$1 million retention.

As of January 1, 2011, the Company renewed its reinsurance contract for its first and second layers of reinsurance. Per the contract renewal, the Company increased its retention at NLIC to \$8 million; therefore, NLIC will have reinsurance for up to \$162 million in losses per event in excess of \$8 million retention. ASIC expanded its underlying coverage to \$7 million excess of \$1 million retention to correspond with the increased NLIC retention. The reinsurance in excess of \$8 million is comprised of four layers of protection: \$17 million in excess of \$8 million retention; \$25 million in excess of \$25 million loss; \$90 million in excess of a \$50 million loss; and \$30 million in excess of a \$140 million loss (the two upper layers also comprise a \$120 million in excess of \$50 million layer). NLIC and ASIC retains no participation in any of the layers, other than the first \$8 million and \$1 million retention, respectively. The projected premiums on these treaties for NLIC and ASIC are \$9.8 and \$1.7 million, respectively, in 2011.

As of December 31, 2010, total retention for any one catastrophe that affects both NLIC and ASIC is limited to \$6 million in the aggregate.



In addition to the catastrophe reinsurance noted above, both NLIC and ASIC participate in an excess of loss program with General Reinsurance Corporation. The General Reinsurance Corporation program is limited to each risk with respect to property and liability in the amount of \$800,000 for each of NLIC and ASIC. Each of NLIC and ASIC retain \$200,000 in this program.

### Liabilities for Unpaid Losses and Loss Adjustment Expenses

NLASCO's liabilities for losses and loss adjustment expenses include liabilities for reported losses, liabilities for incurred but not reported, or IBNR, losses and liabilities for loss adjustment expenses, or LAE, less a reduction for reinsurance recoverables related to those liabilities. The amount of liabilities for reported claims is based primarily on a claim-by-claim evaluation of coverage, liability, injury severity or scope of property damage, and any other information considered relevant to estimating exposure presented by the claim. The amounts of liabilities for IBNR losses and LAE are estimated on the basis of historical trends, adjusted for changes in loss costs, underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors that are subject to significant variation. Liabilities for LAE are intended to cover the ultimate cost of settling claims, including investigation and defense of lawsuits resulting from such claims. Based upon the contractual terms of the reinsurance agreements, reinsurance recoverables offset, in part, NLASCO's gross liabilities.

Significant periods of time can elapse between the occurrence of an insured loss, the reporting of the loss to the insurer and the insurer's payment of that loss. NLASCO's liabilities for unpaid losses represent the best estimate at a given point in time of what it expects to pay claimants, based on facts, circumstances and historical trends then known. During the loss settlement period, additional facts regarding individual claims may become known and, consequently, it often becomes necessary to refine and adjust the estimates of liability.

The table below presents one-year development information on changes in the liability for losses and LAE and a reconciliation of liabilities on a direct premiums written and net premiums written basis for the twelve months ended December 31, 2010 and 2009 (in thousands):

	2010	2009
Balance at January 1,	\$ 33,780	\$ 34,023
Less reinsurance recoverables	(21,102)	(14,613)
Net balance at January 1,	12,678	19,410
Incurring related to:		
Current Year	69,044	71,509
Prior Period	1,899	(1,214)
Total incurred	70,943	70,295
Payments related to:		
Current Year	(59,560)	(61,372)
Prior Year	(8,952)	(15,655)
Total payments	(68,512)	(77,027)
Net balance at December 31,	15,109	12,678
Plus reinsurance recoverables	43,773	21,102
Balance at December 31,	\$ 58,882	\$ 33,780

NLASCO's claim reserving practices are designed to set liabilities for losses and LAE that, in the aggregate, are adequate to pay all claims at their ultimate loss cost, net of anticipated salvage and subrogation. Thus, NLASCO's estimates are not discounted for inflation or other factors.

The reserve for losses and loss adjustment expenses includes amounts that may be due to or from the sellers of NLASCO upon settlement in 2011 based on actual losses incurred applicable to the reserve as of the acquisition date. Incurred amounts related to prior year indicate that we were deficient in incurred but not reported as of December 31, 2009, resulting in an expense in the year ending December 31, 2010. This is due to adverse development on our homeowners and fire products for the 2009 accident year of \$1.0 million and \$0.5 million, respectively, due to an increase in the frequency of our late reported claims. There was also an increase in all other expenses related to a 2008 catastrophe of \$0.6 million. For the year ended December 31, 2009, incurred amounts related to the year ended 2008 were redundant in incurred but not reported due to redundancy attributable to our homeowners product for the 2008 and prior accident years, which resulted in a benefit of \$1.2 million.

### [Table of Contents](#)

### Loss Development

NLASCO estimates the aggregate amount of losses and LAE ultimately required to settle all claims for a given period. The following tables present the development of estimated liability for losses and LAE, net of reinsurance, for the years 2001 through 2010 of NLIC and ASIC. These tables present accident or policy year development data. The first line of the table shows, for the years indicated, net liability, including IBNR, as originally estimated. For example, as of December 31, 2001, NLIC estimated that \$12.2 million would be a sufficient net liability to settle all unsettled claims retained by it that had occurred prior to December 31, 2001, whether reported or unreported. The next section of the table sets forth the re-estimates in later years of incurred losses, including payments, for the years indicated. For example, as indicated in that section of the table, the original net liability of \$12.2 million was re-estimated to be \$12.7 million at December 31, 2005 (four years later). The increase in the original estimate is caused by a combination of factors, including: (1) claims being settled for amounts different than originally estimated; (2) the net liability being increased or decreased for claims remaining open as more information becomes known about those individual claims; and (3) more or fewer claims

being reported after December 31, 2001 than had occurred prior to that date. The bottom section of the table shows, by year, the cumulative amounts of net losses and LAE paid as of the end of each succeeding year. For example, with respect to the liability for net losses and LAE of \$12.2 million as of December 31, 2001, by the end of 2005 (four years later), \$12.6 million had actually been paid in settlement of the claims.

The “net cumulative redundancy (deficiency)” represents, as of December 31, 2010, the difference between the latest re-estimated net liability and the net liability as originally estimated for losses and LAE retained by us. A redundancy means the original estimate was higher than the current estimate; and a deficiency means that the original estimate was lower than the current estimate. For example, as of December 31, 2010 and based upon updated information, NLIC re-estimated that the net liability that was established as of December 31, 2001 was \$0.4 million deficient.

[Table of Contents](#)

The following tables are presented net of reinsurance recoverable.

**National Lloyds Insurance Company  
Analysis of Loss Reserve Development  
(Dollars in Thousands)**

	Year Ended December 31,									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Original Reserve*	12,231	18,141	35,061	33,951	41,282	47,684	44,613	65,592	60,392	55,482
1 year later	12,077	17,852	32,887	28,106	36,332	43,640	44,064	64,864	62,337	
2 years later	12,871	17,281	32,559	27,593	40,391	43,465	44,134	65,070		
3 years later	12,822	17,357	31,614	25,747	41,231	43,394	43,950			
4 years later	12,671	17,340	31,030	25,712	39,735	43,387				
5 years later	12,669	17,312	31,088	25,579	39,699					
6 years later	12,695	17,332	31,072	25,582						
7 years later	12,696	17,321	31,066							
8 years later	12,677	17,307								
9 years later	12,687									
Net cumulative redundancy (deficiency)	(456)	834	3,995	8,369	1,583	4,297	663	522	(1,945)	
Cumulative amount of net liability paid as of:										
1 year later	11,333	16,836	30,867	24,747	32,871	42,301	42,478	63,761	59,977	
2 years later	12,310	17,160	30,818	25,149	34,625	42,668	43,245	64,203		
3 years later	12,612	17,209	30,875	25,388	36,157	43,140	43,495			
4 years later	12,647	17,231	30,989	25,462	39,533	43,361				
5 years later	12,650	17,287	31,026	25,521	39,646					
6 years later	12,676	17,300	31,030	25,538						
7 years later	12,677	17,301	31,029							
8 years later	12,677	17,302								
9 years later	12,687									

\* Including amounts paid in respective year.

[Table of Contents](#)

**American Summit Insurance Company  
Analysis of Loss Reserve Development  
(Dollars in Thousands)**

	Year Ended December 31,									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Original Reserve*	6,621	11,873	6,235	8,297	11,041	13,003	9,351	12,769	9,773	12,486
1 year later	7,630	11,983	5,322	7,388	9,932	13,014	9,154	12,009	9,423	
2 years later	6,742	11,963	5,512	6,999	9,918	12,998	9,335	11,943		
3 years later	6,813	11,554	5,563	6,859	9,918	13,435	9,235			
4 years later	7,106	11,749	5,401	6,772	9,797	13,216				

5 years later	6,732	11,775	5,396	6,714	9,820				
6 years later	6,737	11,799	5,394	6,787					
7 years later	6,735	11,804	5,396						
8 years later	6,735	11,833							
9 years later	6,735								
Net cumulative redundancy (deficiency)	(114)	40	839	1,510	1,221	(213)	116	826	350
Cumulative amount of net liability paid as of:									
1 year later	6,000	10,909	4,987	6,566	9,341	12,429	8,732	11,560	8,800
2 years later	6,281	11,284	5,612	6,610	9,578	12,639	9,095	11,637	
3 years later	6,450	11,647	5,756	6,682	9,679	13,326	9,193		
4 years later	6,760	11,727	5,393	6,699	9,740	13,161			
5 years later	6,727	11,747	5,393	6,714	9,813				
6 years later	6,730	11,759	5,394	6,720					
7 years later	6,735	11,764	5,394						
8 years later	6,735	11,821							
9 years later	6,735								

\* Including amounts paid in respective year.

Please refer to Note 9 in the notes to consolidated financial statements for a reconciliation of the reserves presented in the tables above to the reserves for losses and loss adjustment expenses set forth in the balance sheet at December 31, 2010 and 2009.

Current loss reserve development has been favorable with the exception of accident year 2009. In the years 2007 and 2008, the developed reserves as of December 31, 2010 were \$0.8 million and \$1.3 million, respectively, less than the initial carried reserve for each year. During 2009, however, loss development was unfavorable \$1.6 million mostly due to unfavorable development at NLIC of \$1.9 million. The unfavorable development at NLIC in the accident year 2009 is due to adverse development on our homeowners and fire products of \$1.0 million and \$0.5 million, respectively. For the years 2001 through 2006, the reserves were \$21.9 million favorable. Starting in 2002, IBNR loss reserves were strengthened, contributing to the favorable development in years 2002, 2003 and 2004. This strengthening of reserves was due to increases in direct written premium and increased net written premium from reductions in quota share reinsurance, a form of pro rata insurance.

## [Table of Contents](#)

The following table is a reconciliation of the gross liability to net liability for losses and loss adjustment expenses (dollars in thousands).

	Year Ended December 31,*											
	2000	2001	2002	2003	2004	2005	2006	2007**	2008	2009	2010	
Gross unpaid losses												
Consolidated balance sheet	n/a	n/a	n/a	n/a	n/a	n/a	n/a	\$ 18,091	\$ 34,023	\$ 33,780	\$ 58,882	
Reinsurance recoverable	n/a	n/a	n/a	n/a	n/a	n/a	n/a	(2,692)	(14,613)	(21,102)	(43,773)	
Net unpaid losses	n/a	n/a	n/a	n/a	n/a	n/a	n/a	\$ 15,399	\$ 19,410	\$ 12,678	\$ 15,109	

\* Information is not presented for periods prior to January 31, 2007, as that is the date Hilltop Holdings Inc. acquired the insurance operations.

\*\* Only includes eleven months, as the insurance operations were acquired on January 31, 2007.

## Ratings

Many insurance buyers, agents and brokers use the ratings assigned by A.M. Best and other rating agencies to assist them in assessing the financial strength and overall quality of the companies from which they purchase insurance. The rating for NLIC of "A" (Excellent) was affirmed and ASIC was upgraded to "A" (Excellent) by A.M. Best in April 2010. An "A" rating is the third highest of 16 rating categories used by A.M. Best. In evaluating a company's financial and operating performance, A.M. Best reviews a company's profitability, leverage and liquidity, as well as its book of business, the adequacy and soundness of its reinsurance, the quality and estimated market value of its assets, the adequacy of its liabilities for losses and LAE, the adequacy of its surplus, its capital structure, the experience and competence of its management and its market presence. This rating is intended to provide an independent opinion of an insurer's ability to meet its obligations to policyholders and is not an evaluation directed at investors. This rating assignment is subject to the ability to meet A.M. Best's expectations as to performance and capitalization on an ongoing basis, including with respect to management of liabilities for losses and LAE, and is subject to revocation or revision at any time at the sole discretion of A.M. Best. NLASCO cannot ensure that NLIC and ASIC will maintain their present ratings.

## Investments

HTH's primary investment objectives, as a holding company, are to preserve capital and possess available cash resources to utilize in

making opportunistic acquisitions. Accordingly, HTH, parent only, has \$601.4 million in short-term cash equivalent investments as of December 31, 2010. HTH's management regularly monitors investment performance.

Our insurance operating subsidiary, NLASCO, has primary investment objectives to preserve capital and manage for a total rate of return in excess of a specified benchmark portfolio. The investment strategy of NLASCO's insurance subsidiaries is to purchase securities in sectors that represent what is expected to possess the most attractive relative value. Bonds, cash and short-term investments constituted \$188.2 million, or 95.5%, of NLASCO's investments at December 31, 2010. NLASCO insurance subsidiaries have custodial agreements with A.G. Edwards and Wells Fargo Bank and an investment management agreement with DTF Holdings, LLC.

NLASCO's investment guidelines reflect the desire and intent to assure the prudent investment of capital and surplus, keeping in mind the long-term nature of some insurance reserves, while recognizing the uncertainty of expected cash flows, the shorter term characteristics of and the desire to supplement insurance underwriting gains and offset losses with portfolio income and realized gains in order to maintain adequate capital and surplus. All investments are made in compliance with all state and Federal laws and regulations applicable to such investments and the company involved. State insurance laws and regulations limit the amount of investments in asset classes below certain "quality" levels. NLASCO currently maintains a quality structure exceeding the minimum requirements imposed on the portfolio by state insurance laws and regulations, which is known as the Investment of Insurer's Model Act, or National Association of Insurance Commissioners Act. Currently, NLASCO has no investments in subprime mortgages.

## Table of Contents

Liquidity and preservation of policyholder surplus can be limiting factors in achieving a favorable return on invested assets, as sufficient funds need to be maintained to meet ongoing near term financial obligations. Funds not immediately needed to offset withdrawals may be invested in short-term securities on a continuous basis. A maturity structure must be maintained to invest cash flows from operations and reinvest investment income, as well as to provide a source of liquidity and flexibility to meet changing market, tax and other operating considerations.

Notwithstanding the above, the underlying objective of NLASCO's investment policy is to obtain a favorable total return on invested assets to augment the growth of surplus from operations. Total return comes both from income and capital growth, so a portion of the funds are invested in assets other than fixed income securities, including common stocks and growth oriented preferred stocks. In managing these investment choices, market volatility, the absolute level of NLASCO's capital and surplus relative both to existing liabilities and the level of premium revenue, as well as to total assets, are the limiting factors that influence the portion of assets invested in assets other than fixed income investments.

Performance is measured by comparing the total return, for each period, of each major sector of NLASCO's investment portfolio to an appropriate market index, as well as comparing the total return of NLASCO's investment portfolio to an average of the market indices, weighted by the portfolio's average exposure to each other particular sector during the period. The assets are managed with the goal of exceeding these market indices, with volatility of return similar to or less than the indices.

HTH's investment committee meets regularly to review the portfolio performance and investment markets in general. NLASCO's management generally meets monthly to review the performance of investments and monitor market conditions for investments that would warrant any revision to investment guidelines.

The following table sets forth information concerning the composition of NLASCO's investment portfolio at December 31, 2010 (in thousands):

	<b>December 31, 2010</b>			
	<b>Cost and Amortized Cost</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Percent of Carrying Value</b>
<b>Available-for-sale securities:</b>				
<b>Fixed maturities:</b>				
Government securities	\$ 14,883	\$ 16,001	\$ 16,001	10.7%
Residential mortgage-backed securities	12,563	13,641	13,641	9.2%
Commercial mortgage-backed securities	2,496	2,594	2,594	1.7%
Corporate debt securities	85,402	90,926	90,926	61.0%
	<u>115,344</u>	<u>123,162</u>	<u>123,162</u>	
Equity securities	8,478	8,768	8,768	5.9%
	<u>123,822</u>	<u>131,930</u>	<u>131,930</u>	
<b>Held-to-maturity securities:</b>				
<b>Fixed maturities:</b>				
Government securities	17,035	18,059	17,035	11.4%
	<u>\$ 140,857</u>	<u>\$ 149,989</u>	<u>\$ 148,965</u>	<u>100.0%</u>

At December 31, 2010, NLASCO's fixed maturity portfolio had a fair value of approximately \$141.2 million. All of the fixed maturity investments are rated as investment grade. As a result, the market value of these investments may fluctuate in response to changes in interest rates. In addition, we may experience investment losses to the extent our liquidity needs require disposition of fixed maturity securities in unfavorable interest rate environments.

[Table of Contents](#)

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity securities by major security type and class of security at December 31, 2010 for NLASCO's investment portfolio were as follows (in thousands).

	December 31, 2010			
	Cost and Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
<b>Available-for-sale securities:</b>				
Fixed maturities:				
Government securities	\$ 14,883	\$ 1,118	\$ —	\$ 16,001
Residential mortgage-backed securities	12,563	1,078	—	13,641
Commercial mortgage-backed securities	2,496	98	—	2,594
Corporate debt securities	85,402	5,564	(40)	90,926
	<u>115,344</u>	<u>7,858</u>	<u>(40)</u>	<u>123,162</u>
Equity securities	8,478	290	—	8,768
	<u>123,822</u>	<u>8,148</u>	<u>(40)</u>	<u>131,930</u>
<b>Held-to-maturity securities:</b>				
Fixed maturities:				
Government securities	17,035	1,024	—	18,059
	<u>\$ 140,857</u>	<u>\$ 9,172</u>	<u>\$ (40)</u>	<u>\$ 149,989</u>

During 2010, the Company took other-than-temporary impairment on two commercial mortgage-backed securities, Comm and BSCMS, and recognized a loss in earnings of \$70,000. The Company liquidated Comm in December 2010, and recognized an additional loss of \$13,000.

While all of the investments are monitored for potential other-than-temporary impairment, our experience indicated that other than those impaired, they generally do not present a great risk of impairment, as fair value historically recovers over time. Management believes that the analysis of each of these investments supports the view that these investments were not other-than-temporarily impaired. Evidence considered in this analysis includes the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the steady recovery over time does not warrant other-than-temporary impairment of the securities. The Company does not intend to sell these securities and it is not likely that the Company will be required to sell these securities before the recovery of the cost basis and, therefore, does not believe any other-than-temporary impairments exist, except the other-than-temporary impairment on the aforementioned commercial mortgage backed securities, which occurred during the twelve months ended December 31, 2010.

[Table of Contents](#)

The following table presents the maturity profile of NLASCO's fixed maturity investments as of December 31, 2010. Actual maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities available-for-sale and held-to-maturity at December 31, 2010 by contractual maturity is as follows (in thousands).

	December 31, 2010	
	Amortized Cost	Fair Value
<b>Available-for-sale fixed maturities:</b>		
Due within one year	\$ 8,228	\$ 8,420
Due after one year through five years	58,959	62,339
Due six years through ten years	33,588	36,668
Due after ten years	3,972	4,320
Mortgage-backed securities	10,597	11,415
	<u>\$ 115,344</u>	<u>\$ 123,162</u>
<b>Held-to-maturity debt securities:</b>		
Due within one year	\$ 201	\$ 204



Due after one year through five years	12,171	12,749
Due six years through ten years	4,663	5,106
	<u>\$ 17,035</u>	<u>\$ 18,059</u>

We are subject to various market risk exposures, including interest rate risk and equity price risk. Our primary risk exposure is to changes in interest rates. We manage market risk through our investment committee and through the use of an outside professional investment management firm. We are vulnerable to interest rate changes, like other insurance companies, because we invest primarily in fixed maturity securities, which are interest-sensitive assets. Mortgage-backed securities, which make up approximately 9.2% of our available-for-sale fixed maturities, are particularly susceptible to interest rate changes.

The value of our equity investments is dependent upon general conditions in the securities markets and the business and financial performance of the individual companies in the portfolio. Values are typically based on future economic prospects that are perceived by investors in the equity market.

## Competition

NLASCO competes with a large number of other companies in its selected lines of business, including major U.S. and non-U.S. insurers, regional companies, mutual companies, specialty insurance companies, underwriting agencies and diversified financial services companies. The personal lines market in Texas is dominated by a few large carriers and their subsidiaries and affiliates, including State Farm, Zurich Insurance Group, Allstate and USAA. According to the Texas Department of Insurance, the top ten insurers writing homeowners insurance accounted for approximately 82.3% of the market for the trailing twelve months at September 30, 2010. NLASCO competes for business on the basis of a number of factors, including price, coverages offered, customer service, relationships with agents (including ease of doing business, service provided and commission rates paid), size and financial strength ratings. In its personal lines business, NLASCO's competitors include Republic Companies Group, Inc., Columbia Lloyds, Foremost, American Modern Home Group and American Reliable. In its commercial lines business, NLASCO's competitors include Travelers, Safeco and Republic. NLASCO seeks to distinguish itself from its competitors by targeting underserved market segments that provide NLASCO with the best opportunity to obtain favorable policy terms, conditions and pricing.

## Regulation of Insurance Activities

NLASCO's insurance subsidiaries, NLIC and ASIC, are subject to regulation and supervision in each state where they are licensed to do business. This regulation and supervision is vested in state agencies having broad administrative power over the various aspects of the business of NLIC and ASIC.

---

## [Table of Contents](#)

### *State insurance holding company regulation*

NLASCO controls two operating insurance companies, NLIC and ASIC, and is subject to the insurance holding company laws of Texas, the state in which those insurance companies are domiciled. These laws generally require NLASCO to register with the Texas Department of Insurance and periodically to furnish financial and other information about the operations of companies within its holding company structure. Generally under these laws, all transactions between an insurer and an affiliated company in its holding company structure, including sales, loans, reinsurance agreements and service agreements, must be fair and reasonable and, if satisfying a specified threshold amount or of a specified category, require prior notice and approval or non-disapproval by the Texas Department of Insurance.

### *Changes of control*

Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the Texas Department of Insurance. Prior to granting approval of an application to acquire control of an insurer, the Texas Department of Insurance will consider the following factors, among others:

- the financial strength of the applicant;
- the integrity and management experience of the applicant's board of directors and executive officers;
- the acquirer's plans for the management of the domestic insurer;
- the acquirer's plans to declare dividends, sell assets or incur debt;
- the acquirer's plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and
- any anti-competitive results that may arise from the consummation of the acquisition of control.

Pursuant to the Texas insurance holding company statutes, "control" means the possession, direct or indirect, of the power to direct, or

cause the direction of, the management and policies of the company, whether through the ownership of voting securities, by contract (except a commercial contract for goods or non-management services) or otherwise. Control is presumed to exist if any person directly or indirectly owns, controls or holds with the power to vote 10% or more of the voting securities of the company; however, the state's insurance department, after notice and a hearing, may determine that a person or entity that directly or indirectly owns, controls or holds with the power to vote less than 10% of the voting securities of the company nonetheless "controls" the company. Because a person acquiring 10% or more of HTH's common stock would indirectly control the same percentage of the stock of ASIC and two affiliated corporations controlling NLIC, the change of control laws of the State of Texas would apply to such a transaction.

These laws may discourage potential acquisition proposals and may delay, deter or prevent change of control transactions, including those that some or all of the Company's stockholders might consider to be desirable.

### ***National Association of Insurance Commissioners***

The National Association of Insurance Commissioners, or NAIC, is a group consisting of state insurance commissioners that discuss issues and formulates policy with respect to regulation, reporting and accounting for insurance companies. Although the NAIC has no legislative authority and insurance companies are at all times subject to the laws of their respective domiciliary states and, to a lesser extent, other states in which they conduct business, the NAIC is influential in determining the form in which such laws are enacted. Certain Model Insurance Laws, Regulations and Guidelines, or Model Laws, have been promulgated by the NAIC as a minimum standard by which state regulatory systems and regulations are measured. Adoption of state laws that provide for substantially similar regulations to those described in the Model Laws is a requirement for accreditation by the NAIC.

The NAIC provides authoritative guidance to insurance regulators on current statutory accounting issues by promulgating and updating a codified set of statutory accounting practices in its Accounting Practices and Procedures Manual. The Texas Department of Insurance has generally adopted these codified statutory accounting practices.

### **Table of Contents**

Texas also has adopted laws substantially similar to the NAIC's risk based capital, or RBC laws, which require insurers to maintain minimum levels of capital based on their investments and operations. Domestic property and casualty insurers are required to report their RBC based on a formula that attempts to measure statutory capital and surplus needs based on the risks in the insurer's mix of products and investment portfolio. The formula is designed to allow the Texas Department of Insurance to identify potential inadequately capitalized companies. Under the formula, a company determines its RBC by taking into account certain risks related to its assets (including risks related to its investment portfolio and ceded reinsurance) and its liabilities (including underwriting risks related to the nature and experience of its insurance business). Among other requirements, an insurance company must maintain capital and surplus of at least 200% of the RBC computed by the NAIC's RBC model (known as the "Authorized Control Level" of RBC). At December 31, 2010, NLIC and ASIC capital and surplus levels exceeded the minimum RBC requirements that would trigger regulatory attention. In their 2010 statutory financial statements, both NLIC and ASIC complied with the NAIC's RBC reporting requirements.

The NAIC's Insurance Regulatory Information System, or IRIS, was developed to assist state insurance departments in executing their statutory mandates to oversee the financial condition of insurance companies. IRIS identifies twelve industry ratios and specifies a range of "usual values" for each ratio. Departure from the usual values on four or more of these ratios can lead to inquiries from state insurance commissioners as to certain aspects of an insurer's business. For 2010, all ratios for both NLIC and ASIC were within the usual values.

The NAIC adopted an amendment to its "Model Audit Rule" in response to the passage of the Sarbanes-Oxley Act of 2002, or SOX. The amendment is effective for financial statements for accounting periods after January 1, 2010. This amendment addresses auditor independence, corporate governance and, most notably, the application of certain provisions of Section 404 of SOX regarding internal control reporting. The rules relating to internal controls apply to insurers with gross direct and assumed written premiums of \$500 million or more, measured at the legal entity level (rather than at the insurance holding company level), and to insurers that the domiciliary commissioner selects from among those identified as in hazardous condition, but exempts SOX compliant entities. Neither NLIC nor ASIC currently has direct and assumed written premiums of at least \$500 million, but it is conceivable that this may change in the future; however, NLASCO must be SOX compliant because it is wholly-owned by HTH, a public company subject to SOX.

### ***Legislative changes***

From time to time, various regulatory and legislative changes have been, or are, proposed that would adversely affect the insurance industry. Among the proposals that have been, or are being, considered are the possible introduction of Federal regulation in addition to, or in lieu of, the current system of state regulation of insurers and proposals in various state legislatures (some of which proposals have been enacted) to conform portions of their insurance laws and regulations to various Model Laws adopted by the NAIC. NLASCO is unable to predict whether any of these laws and regulations will be adopted, the form in which any such laws and regulations would be adopted, or the effect, if any, these developments would have on its financial condition or results of operations.

In 2002, in response to the tightening supply in certain insurance and reinsurance markets resulting from, among other things, the September 11, 2001 terrorist attacks, the Terrorism Risk Insurance Act, or TRIA, was enacted. TRIA was modified and extended by the Terrorism Risk Insurance Extension Act of 2005 and extended again by the Terrorism Risk Insurance Program Reauthorization Act of 2007. These Acts created a Federal Program designed to ensure the availability of commercial insurance coverage for terrorist acts in the United States. This Program helped the commercial property and casualty insurance industry cover claims related to terrorism-related losses and requires such companies to offer coverage for certain acts of terrorism. As a result, NLASCO is prohibited from adding certain terrorism exclusions to the policies written by its insurance company subsidiaries. The 2005 Act extended the Program through 2007, but eliminated commercial auto, farm-owners and certain other

commercial coverages from its scope. The Reauthorization Act further extended the Program through December 31, 2014 and fixed the reimbursement percentage at 85% and the deductible at 20%. Although NLASCO is protected by federally funded terrorism reinsurance as provided for in the TRIA, there is a substantial deductible that must be met, the payment of which could have an adverse effect on its financial condition and results of operations. NLASCO's deductible for 2010 was \$1.4 million. Potential future changes to the TRIA could also adversely affect NLASCO by causing its reinsurers to increase prices or withdraw from certain markets where terrorism coverage is required.

## Table of Contents

In 2003, legislation was passed in Texas that significantly changed the regulation of homeowners insurance, and, to a lesser extent, automobile insurance. Prior to 2003, certain types of insurers, including insurance companies that participate in Lloyd's, reciprocals, county mutuals and farm mutuals that wrote these lines of insurance were generally exempt from rate regulation. The 2003 legislation eliminated, or severely reduced, these exemptions, and imposed a new rate regulation regime for all insurers writing these lines of insurance. This legislation also included limitations on the use of credit scoring and territorial distinctions in underwriting and rating risks. Further, the Texas Commissioner of Insurance has been given broader authority under the law to order refunds to policyholders when rates charged have been deemed excessive or unfairly discriminatory.

The Texas Sunset Act provides that the Sunset Commission, composed of legislators and public members, periodically evaluate a state agency to determine if the agency is still needed, and what improvements are needed to ensure that state funds are well spent. Based on the recommendations of the Sunset Commission, the Texas Legislature ultimately decides whether an agency continues to operate into the future. The Sunset Commission reviewed the Texas Department of Insurance in 2008 and made recommendations on the agency to the 81<sup>st</sup> Texas legislative session, which occurred in 2009. The legislation containing the Sunset Commission's recommendations, however, failed to pass. The Texas Legislature, instead, passed legislation that continues the agency until 2011 and limits the Sunset Commission's review of the Texas Department of Insurance to the appropriateness of the recommendations made during the 81<sup>st</sup> legislative session. The Sunset Commission staff concluded the majority of the Sunset's previous recommendations remain appropriate in their formal report issued in July 2010. Based on public input and the Sunset Commission staff report, the Sunset Commission will adopt recommendations for the legislature to consider when it convenes in January 2011 for the 82<sup>nd</sup> Texas legislative session. As of March 9, 2011, the legislature had not addressed the Sunset Commission's recommendations. Accordingly, it is likely that changes will occur as a result of this review, which may have an adverse effect on us.

### ***State insurance regulations***

State insurance authorities have broad powers to regulate U.S. insurance companies. The primary purposes of these powers are to promote insurer solvency and to protect individual policyholders. The extent of regulation varies, but generally has its source in statutes that delegate regulatory, supervisory and administrative power to state insurance departments. These powers relate to, among other things, licensing to transact business, accreditation of reinsurers, admittance of assets to statutory surplus, regulating unfair trade and claims practices, establishing actuarial requirements and solvency standards, regulating investments and dividends, and regulating policy forms, related materials and premium rates. State insurance laws and regulations require insurance companies to file financial statements prepared in accordance with accounting principles prescribed by insurance departments in states in which they conduct insurance business, and their operations are subject to examination by those departments.

As part of the broad authority that state insurance commissioners hold, they may impose periodic rules or regulations related to local issues or events. An example is the State of Louisiana's prohibition on the cancellation of policies for nonpayment of premium in the wake of Hurricane Katrina. Due to the extent of damage and displacement of people, inability of mail to reach policyholders and inaccessibility of entire neighborhoods, the State of Louisiana prohibited insurance companies from canceling policies for a period of time following that named storm.

### ***Periodic financial and market conduct examinations***

The insurance departments in every state in which NLASCO's insurance companies do business may conduct on-site visits and examinations of its insurance companies at any time to review the insurance companies' financial condition, market conduct and relationships and transactions with affiliates. In addition, the Texas Department of Insurance will conduct comprehensive examinations of insurance companies domiciled in Texas every three to five years. Examinations are generally carried out in cooperation with the insurance departments of other licensing states under guidelines promulgated by the NAIC.

The Texas Department of Insurance completed their examination of NLIC from January 31, 2002 through December 31, 2006, and ASIC from January 1, 2004 through December 31, 2006. The final NLIC and ASIC examination reports dated June 13, 2008 and June 1, 2008, respectively, contained no information of any significant compliance issues.

On October 29, 2010 and November 1, 2010, ASIC and NLIC, respectively, were notified by the Texas Department of Insurance that a statutory examination has been scheduled in the calendar year 2011/2012. The examination will be as of December 31, 2010, and cover the period since the last examination, which was as of December 31, 2006. We do not expect any significant changes to our financial statements as a result of the examinations by the domiciliary state.

## Table of Contents

### ***State dividend limitations***

The Texas Department of Insurance must approve any dividend declared or paid by an insurance company domiciled in the state if the dividend, together with all dividends declared or distributed by that insurance company during the preceding twelve months, exceeds the greater of (1) 10% of its policyholders' surplus as of December 31 of the preceding year or (2) 100% of its net income for the preceding calendar year. The greater number is known as the insurer's extraordinary dividend limit. As of December 31, 2010, the extraordinary dividend limit for NLIC and ASIC is \$9.4 million and \$2.5 million, respectively. In addition, NLASCO's insurance companies may only pay dividends out of their earned surplus.

### ***Statutory accounting principles***

Statutory accounting principles, or SAP, are a comprehensive basis of accounting developed to assist insurance regulators in monitoring and regulating the solvency of insurance companies. SAP rules are different from generally accepted accounting principles in the United States of America, or GAAP, and are intended to reflect a more conservative view of the insurer. SAP is primarily concerned with measuring an insurer's surplus to policyholders. Accordingly, SAP focuses on valuing assets and liabilities of insurers at financial reporting dates in accordance with insurance laws and regulatory provisions applicable in each insurer's domiciliary state.

While GAAP is concerned with a company's solvency, it also stresses other financial measurements, such as income and cash flows. Accordingly, GAAP gives more consideration to appropriate matching of revenues and expenses and accounting for management's stewardship of assets than does SAP. As a direct result, different assets and liabilities and different amounts of assets and liabilities will be reflected in financial statements prepared in accordance with GAAP as opposed to SAP. SAP, as established by the NAIC and adopted by Texas regulators, determines the statutory surplus and statutory net income of the NLASCO insurance companies and, thus, determines the amount they have available to pay dividends.

### ***Guaranty associations***

In Texas, and in all of the jurisdictions in which NLIC and ASIC are, or in the future may be, licensed to transact business, there is a requirement that property and casualty insurers doing business within the jurisdiction must participate in guaranty associations, which are organized to pay limited covered benefits owed pursuant to insurance policies issued by impaired, insolvent or failed insurers. These associations levy assessments, up to prescribed limits, on all member insurers in a particular state on the basis of the proportionate share of the premiums written by member insurers in the lines of business in which the impaired, insolvent or failed insurer was engaged. States generally permit member insurers to recover assessments paid through full or partial premium tax offsets.

NLASCO incurred no levies in 2010, 2009 or 2008. Property and casualty insurance company insolvencies or failures may, however, result in additional guaranty fund assessments at some future date. At this time NLASCO is unable to determine the impact, if any, that these assessments may have on its financial condition or results of operations. NLASCO has established liabilities for guaranty fund assessments with respect to insurers that are currently subject to insolvency proceedings.

### ***National Flood Insurance Program***

NLASCO voluntarily participates as a Write Your Own carrier in the National Flood Insurance Program, or NFIP. The NFIP is administered and regulated by the Federal Emergency Management Agency (FEMA). NLASCO operates as a fiscal agent of the Federal government in the selling and administering of the Standard Flood Insurance Policy. This involves writing the policy, the collection of premiums and the paying of covered claims. All pricing is set by FEMA and all collections are made by the Company.

The Company cedes 100% of the policies written by the Company on the Standard Flood Insurance Policy to FEMA; however, if FEMA were unable to perform, the Company would have a legal obligation to the policyholders. The terms of the reinsurance agreement are standard terms, which require the Company to maintain its rating criteria, determine policyholder eligibility, issue policies on the Company's paper, endorse and cancel policies, collect from insured and process claims. NLASCO receives ceding commissions from NFIP for underwriting administration, claims management, commission and adjuster fees.

---

## **Table of Contents**

### ***Participation in involuntary risk plans***

NLASCO's insurance companies are required to participate in residual market or involuntary risk plans in various states where they are licensed that provide insurance to individuals or entities that otherwise would be unable to purchase coverage from private insurers. If these plans experience losses in excess of their capitalization, they may assess participating insurers for proportionate shares of their financial deficit. These plans include the Georgia Underwriting Association, Texas FAIR Plan Association, Texas Windstorm Insurance Agency, or TWIA, the Louisiana Citizens Property Insurance Corporation, the Mississippi Residential Property Insurance Underwriting Association and the Mississippi Windstorm Underwriting Association. For example in 2005, following Hurricanes Katrina and Rita, the above plans levied collective assessments totaling \$10.4 million on NLASCO's insurance subsidiaries. Additional assessments, including emergency assessments, may follow. In some of these instances, NLASCO's insurance companies should be able to recover these assessments through policyholder surcharges, higher rates or reinsurance. The ultimate impact hurricanes have on the Texas and Louisiana facilities is currently uncertain and future assessments can occur whenever the involuntary facilities experience financial deficits.

### ***Other***

Insurance activities are subject to state insurance laws and regulations as determined by the particular insurance commissioner for each state in accordance with the McCarran-Ferguson Act, as well as subject to the Gramm-Leach-Bliley Act and the privacy regulations promulgated by

the Federal Trade Commission.

Changes in any of the laws governing our conduct could have an adverse impact on our ability to conduct our business or could materially affect our financial position, operating income, expense or cash flow.

## Employees

As of December 31, 2010, we had 133 full-time equivalent employees. Of these 133 employees, 4 work for HTH, and the remaining 129 work for NLASCO. The NLASCO employees perform underwriting, claims, marketing, and administrative functions for the insurance business. We consider our employee relations to be good.

---

## [Table of Contents](#)

### ITEM 1A. RISK FACTORS

*The following risk factors identify important factors, including material risks and uncertainties, which could cause actual results to differ materially from those reflected in forward-looking statements or in our historical results. Each of the following risk factors, among others, could adversely affect our ability to meet the current expectations of our management.*

#### **Risks Related to Our Substantial Cash Position and Related Strategies for its Use**

*We intend to use a substantial portion of our available cash to make acquisitions or effect a business combination.*

We are endeavoring to make opportunistic acquisitions or effect a business combination with a substantial portion of our available cash. No assurances, however, can be given that we will be able to identify suitable targets, consummate acquisitions or effect a combination or, if consummated, successfully integrate personnel and operations. Even if we identify suitable targets, we may not be able to make acquisitions or effect a combination on commercially acceptable terms, if at all. The success of any acquisition or combination will depend upon, among other things, the ability of management and our employees to integrate personnel, operations, products and technologies effectively, to retain and motivate key personnel and to retain customers and clients of targets. In addition, any acquisition or combination we undertake may involve certain other risks, including consumption of available cash resources, potentially dilutive issuances of equity securities and the diversion of management's attention from other business concerns. We also may need to make further investments to support the acquired or combined company and may have difficulty identifying and acquiring the appropriate resources. There can be no assurance that any acquisition or combination we undertake will perform as expected. We may enter, on our own and through acquisitions or a combination, into new lines of business or initiate new service offerings, whether related or unrelated to our insurance business. Our success in any such endeavor will depend upon, among other things, the ability of management to identify suitable opportunities, successfully implement sound business strategies and avoid the legal and business risks of any new line of business or service offering and/or an acquisition related thereto. There can be no assurance that we will be able to do any of the foregoing. In addition, any such undertakings may result in additional costs without an immediate increase in revenues and may divert management's attention from the operation and growth of our current lines of business.

*Since we have not definitively selected a particular target business to acquire or combine with, you will be unable to ascertain the merits or risks of the industry or business in which we may ultimately primarily operate.*

We may consummate an acquisition of, or effect a business combination with, a company in any industry and are not limited to any particular type of business. Accordingly, there is no basis for you to evaluate the possible merits or risks of the particular industry in which we may ultimately conduct our primary ongoing operations or the target business that we may ultimately acquire. To the extent that we complete an acquisition of, or effect a business combination with, a financially unstable company or an entity in its development stage, we may be affected by numerous risks inherent in the business operations of those entities. If we complete an acquisition of, or effect a business combination with, an entity in an industry characterized by a high level of risk, we may be affected by the unascertainable risks of that industry. Although our management will endeavor to evaluate the risks inherent in a particular industry or target business, we cannot assure you that we will properly ascertain or assess all of the significant risk factors. Even if we properly assess those risks, some of them may be outside of our control or ability to affect.

*We may change our primary lines of business without stockholder approval, which may result in riskier lines of business than our current lines of business.*

Depending on the structure of an acquisition or business combination, it may result in us conducting our primary operations in lines of business that are different from, and possibly more risky than, our current business without stockholder approval.

*Resources could be expended in researching acquisitions that are not consummated, which could materially adversely affect subsequent attempts to locate and acquire or merge with another business.*

It is anticipated that the investigation of each specific target business and the negotiation, drafting and execution of relevant agreements, disclosure documents and other instruments will require substantial management time and attention and substantial costs for accountants, attorneys and others. If a decision is made not to complete a specific acquisition or business combination, the costs incurred up to that point for the proposed transaction likely would not be recoverable. Furthermore, even if an agreement is reached relating to a specific target business, we may fail to consummate our acquisition or combination for any number of reasons, including those beyond our control, such as if the target's stockholders do not approve the transaction. Any such event will result in a loss to us of the related costs incurred, which could materially



---

[Table of Contents](#)

***Existing circumstances may result in several of our directors having interests that may conflict with our interests.***

A director who has a conflict of interest with respect to an issue presented to our board will have no inherent legal obligation to abstain from voting upon that issue. We do not have provisions in our bylaws or charter that require an interested director to abstain from voting upon an issue, and we do not expect to add provisions in our charter and bylaws to this effect. Although each director has a duty to act in good faith and in a manner he or she reasonably believes to be in our best interests, there is a risk that, should interested directors vote upon an issue in which they or one of their affiliates has an interest, their vote may reflect a bias that could be contrary to our best interests. In addition, even if an interested director abstains from voting, the director's participation in the meeting and discussion of an issue in which they have, or companies with which they are associated have, an interest could influence the votes of other directors regarding the issue.

***Difficult market conditions have adversely affected the yield on our available cash.***

Our primary objective is to preserve and maintain the liquidity of our available cash, while at the same time maximizing yields without significantly increasing risk. The capital and credit markets have been experiencing volatility and disruption for a prolonged period. This volatility and disruption reached unprecedented levels, resulting in dramatic declines in interest rates and other yields relative to risk. This downward pressure has negatively affected the yields we receive on our available cash. If current levels of market disruption and volatility continue or worsen, there can be no assurance that we will receive any significant yield on our available cash. Further, given current market conditions, no assurance can be given that we will be able to preserve our available cash.

***Competition from other motivated purchasers may hinder our ability to consummate an acquisition in the near term.***

We expect to encounter intense competition from entities having a business objective similar to ours, including venture capital funds, special purpose acquisition companies, private equity funds, leveraged buyout funds, opportunity funds and other operating businesses competing for acquisitions. Many of these entities are well established and have extensive experience in identifying and effecting acquisitions or business combinations directly or through affiliates. Many of these competitors possess greater technical, human and other resources than we do and our financial resources may be relatively limited when contrasted with those of many of these competitors. While we believe that there are numerous potential target businesses that we could acquire with our available cash, our ability to compete in acquiring certain sizable target businesses may be limited by our available financial resources. This inherent competitive limitation gives others an advantage in pursuing the acquisition of certain target businesses. For these reasons, we cannot assure you that we will be able to effectuate an acquisition or business combination in the near term.

***Following the consummation of an acquisition or business combination, we may be required to take write-downs or write-offs or restructuring, impairment or other charges that could have a significant negative effect on our financial condition, results of operations and our stock price.***

Even if we conduct extensive due diligence on a target business that we acquire or with which we merge, we cannot assure you that this diligence will surface all material issues that may be present inside a particular target business, that it would be possible to uncover all material issues through a customary amount of due diligence, or that factors outside of the target business and outside of our control will not later arise. As a result of these factors, we may be forced to later write-down or write-off assets, restructure our operations or incur impairment or other charges that could result in us reporting losses. Even if our due diligence successfully identifies certain risks, unexpected risks may arise and previously known risks may materialize in a manner inconsistent with our preliminary risk analysis. Even though these charges may be non-cash items and not have an immediate impact on our liquidity, the fact that we report charges of this nature could contribute to negative market perceptions about us or our securities. In addition, charges of this nature may cause us to violate net worth or other covenants to which we may become subject as a result of assuming pre-existing debt held by a target business or by virtue of our obtaining post-acquisition debt financing.

---

[Table of Contents](#)

***We may issue shares of preferred stock or additional shares of common stock to complete an acquisition or effect a combination or under an employee incentive plan after consummation of an acquisition or combination, which would dilute the interests of our stockholders and likely present other risks.***

The issuance of shares of preferred stock or additional shares of common stock:

- may significantly dilute the equity interest of our stockholders;
- may subordinate the rights of holders of common stock if preferred stock is issued with rights senior to those afforded our common stock;
- could cause a change in control if a substantial number of shares of common stock are issued, which may affect, among other things, our ability to use our net operating loss carry forwards; and
- may adversely affect prevailing market prices for our common stock.

***We may be unable to obtain additional financing to complete an acquisition or business combination or to fund the operations and growth of a target business, which could compel us to restructure or abandon a particular acquisition or business combination.***

Although we believe that our available cash will be sufficient to allow us to consummate an acquisition or effect a business combination, we cannot ascertain the exact capital requirements for any particular transaction because we have not yet definitively selected a target business. If our available cash is insufficient, either because of the size of the acquisition or business combination or the depletion of available funds in search of a target business, we may be required to seek additional financing. We cannot assure you that such financing will be available on acceptable terms, if at all. To the extent that additional financing proves to be unavailable, if and when needed, to consummate an acquisition or effect a business combination, we would be compelled to either restructure the transaction or abandon that particular acquisition or business combination and seek an alternative target business candidate. Even if we do not need additional financing to consummate an acquisition or effect a business combination, we may require such financing to fund the operations or growth of the target business. The failure to secure additional financing could have a material adverse effect on the continued development or growth of the target.

***There may be tax consequences with respect to an acquisition or business combination that adversely affect us.***

While we expect to undertake any merger or acquisition so as to minimize taxes, both to the acquired business and/or asset and us, such acquisition or business combination might not meet the statutory requirements of a tax-free reorganization, or the parties might not obtain the intended tax-free treatment upon a transfer of shares or assets. A non-qualifying reorganization could result in the imposition of substantial taxes.

Our net operating loss and other carryovers may be limited if we undergo an ownership change. Generally, an ownership change occurs if certain persons or groups increase their aggregate ownership in us by more than 50 percentage points looking back over the prior three-year period. If an ownership change occurs, our ability to use our net operating losses, or NOLs, to reduce income taxes is limited to an annual amount, or a Section 382 limitation, equal to the fair market value of our common stock immediately prior to the ownership change multiplied by the long term tax-exempt interest rate, which is published monthly by the Internal Revenue Service, or IRS. In the event of an ownership change, NOLs that exceed the Section 382 limitation in any year will continue to be allowed as carryforwards for the remainder of the carryforward period and such excess NOLs can be used to offset taxable income for years within the carryforward period subject to the Section 382 limitation in each year. Whether or not an ownership change occurs, the carryforward period for NOLs is either 15 or 20 years from the year in which the losses giving rise to the NOLs were incurred. If the carryforward period for any NOL were to expire before that NOL had been fully utilized, the unused portion of that NOL would be lost.

Based on our knowledge of stockholder ownership of Hilltop, we do not believe that an ownership change has occurred since our initial public offering, or IPO, that would limit our post-IPO NOLs. Accordingly, we believe that there is no Section 382 limitation imposed on our use of post-IPO NOLs to reduce future taxable income.

---

## [Table of Contents](#)

The determination of whether an ownership change has occurred, or will occur, is complicated, and therefore, no assurance can be provided as to whether an ownership change has occurred or will occur. We have not obtained, and currently do not plan to obtain, an IRS ruling or opinion of counsel regarding our conclusions as to whether the pre-IPO NOLs or post-IPO NOLs are subject to any such limitations. In addition, limitations imposed by Section 382 may prevent us from issuing additional shares of common stock to raise capital or to acquire businesses or properties. To the extent not prohibited by our charter, we may decide in the future that it is necessary or in our best interest to take certain actions that could result in an ownership change.

***If we are deemed to be an investment company, we may be required to institute burdensome compliance requirements and our activities may be restricted, which may make it difficult for us to complete strategic acquisitions or effect combinations.***

We do not plan to operate as an investment fund or investment company, or to be engaged in the business of investing, reinvesting or trading in securities. Our primary plan is to acquire, hold, operate and grow for the long-term, one or more operating businesses.

If we were deemed to be an investment company under the Investment Company Act of 1940, or the 1940 Act, we would be required to become registered under the 1940 Act (or liquidate) and our activities would be subject to a number of restrictions, including, among others:

- corporate governance requirements and requirements regarding mergers and share exchanges;
- restrictions on the nature of our investments;
- restrictions on our capital structure and use of multiple classes of securities; and
- restrictions on our use of leverage and collateral, each of which may make it difficult for us to consummate strategic acquisitions or effect a combination.

In addition, we may have imposed upon us burdensome requirements, including:

- registration as an investment company;
- adoption of a specific form of corporate structure; and
- reporting, record keeping, voting, proxy and disclosure requirements and other rules and regulations,
- compliance with which would reduce the funds that we have available to consummate strategic acquisitions or a combination.

In order not to be regulated as an investment company under the 1940 Act, unless we can qualify for an exclusion, we must ensure that we are engaged primarily in an initial business other than investing, reinvesting or trading of securities and that our activities do not include investing,

reinvesting, owning, holding or trading “investment securities.” Our primary business, in addition to our insurance operations, will be to identify and consummate an acquisition or effect a business combination and, thereafter, to operate the acquired business or businesses for the long term. We do not believe that our anticipated principal activities will subject us to the 1940 Act. If we were deemed to be subject to the 1940 Act, compliance with these additional regulatory burdens would require additional expense for which we have not accounted.

---

[Table of Contents](#)

**Risks Related to NLASCO’s Business and NLASCO’s Industry**

***The occurrence of severe catastrophic events may have a material adverse effect on NLASCO, particularly because NLASCO conducts business in a concentrated geographic area.***

NLASCO expects to have large aggregate exposures to natural and man-made disasters, such as hurricanes, hail, tornados, windstorms, wildfires and acts of terrorism. NLASCO expects that its loss experience, generally, will include infrequent events of great severity. Hurricanes Dolly, Gustav and Ike, which occurred in 2008, are examples. The risks associated with natural and man-made disasters are inherently unpredictable, and it is difficult to predict the timing of these events with statistical certainty or estimate the amount of loss any given occurrence will generate. Although NLASCO may attempt to exclude certain losses, such as terrorism and other similar risks, from some coverage that NLASCO writes, it may be prohibited from, or may not be successful in, doing so. The extent of losses from a catastrophe is a function of both the total amount of policyholder exposure in the geographic area affected by the event and the severity of the event. The occurrence of losses from catastrophic events may have a material adverse effect on NLASCO’s ability to write new business and on its financial condition and results of operations. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and NLASCO expects that these factors will increase the severity of losses in the future. Factors that may influence NLASCO’s exposure to losses from these types of events, in addition to the routine adjustment of losses, include, among others:

- exhaustion of reinsurance coverage;
- increases in reinsurance rates;
- unanticipated litigation expenses;
- unrecoverability of ceded losses;
- impact on independent agent operations and future premium income in areas affected by catastrophic events;
- unanticipated expansion of policy coverage or reduction of premium due to regulatory, legislative and/or judicial action following a catastrophic event; and
- unanticipated demand surge related to other recent catastrophic events.

NLASCO’s insurance subsidiaries write insurance primarily in the States of Texas, Arizona, Tennessee, Oklahoma, Georgia and Louisiana. In 2010, Texas accounted for 73.2%, Arizona accounted for 8.2%, Tennessee accounted for 6.3%, Oklahoma accounted for 5.0%, Georgia accounted for 2.4%, Louisiana accounted for 2.2% and the other states we do business in accounted for the other 2.7% of our premiums. As a result, a single catastrophe, destructive weather pattern, wildfire, terrorist attack, regulatory development or other condition or general economic trend affecting these regions or significant portions of these regions could adversely affect NLASCO’s financial condition and results of operations more significantly than other insurance companies that conduct business across a broader geographic area. Although NLASCO purchases catastrophe reinsurance to limit its exposure to these types of catastrophes, in the event of one or more major catastrophes resulting in losses to it in excess of \$170.0 million, NLASCO’s losses would exceed the limits of its reinsurance coverage.

***NLASCO is exposed to claims related to severe weather and the occurrence of severe weather may result in an increase in claims frequency and exposure amount that could materially adversely affect its financial condition.***

NLASCO is subject to claims arising out of severe weather, such as hurricanes, tornados, rainstorms, snowstorms, hailstorms, windstorms and ice storms, which may have a significant effect on its financial condition and results of operations. The majority of its business is written in Texas, Arizona, Tennessee and Oklahoma, and Texas experienced two major hurricanes in 2008. The incidence and severity of weather conditions are inherently unpredictable. Some forecasters predict that the world is currently in a cycle of increased frequency of, and more severe, hurricanes and destructive weather patterns.

Generally, NLASCO’s insured risks exhibit higher losses in the second and third calendar quarters due to a seasonal concentration of weather-related events in its primary geographic markets. Although weather-related losses (including hail, high winds, tornadoes and hurricanes) can occur in any calendar quarter, the second calendar quarter, historically, has experienced the highest frequency of losses associated with these events. For example, for the last five years, the contribution of weather-related catastrophes to the consolidated second calendar quarter net loss ratio was on average approximately 18 points greater than the average contribution of such catastrophes in the other three calendar quarters. Hurricanes, however, are more likely to occur in the third calendar quarter of the year.

---

[Table of Contents](#)

NLASCO incurred \$33.4 million (including loss adjustment expenses) in gross catastrophic related losses for the year ended December 31, 2010. During 2010, NLASCO’s net catastrophic loss experience was \$3.5 million after reinsurance and decreases in net premiums earned due to reinsurance reinstatement premiums. A substantial portion of the expense in 2010 relates to claims being paid or reserved on hail and windstorms occurring in Oklahoma and Arizona, respectively. NLASCO incurred \$17.9 million (including loss adjustment expenses) in gross catastrophic

related losses for the year ended December 31, 2009. During 2009, NLASCO's net catastrophic loss experience was \$0.9 million after reinsurance and decreases in net premiums earned due to reinsurance reinstatement premiums. A substantial portion of the expense in 2009 relates to claims being paid or reserved on hail and windstorms occurring in Texas.

***Due to the inherent inability to accurately predict the severity and frequency of catastrophic losses, higher than expected catastrophic losses could materially adversely affect NLASCO's financial condition.***

NLASCO utilizes catastrophe modeling to assess its probable maximum insurance losses from hurricane and other wind/hail perils and to structure its catastrophe reinsurance program to minimize its exposure to high severity/high frequency types of losses. Hurricanes Ike, Katrina and Rita highlighted the challenges inherent in predicting the impact of catastrophic events. The catastrophe models, generally, failed to adequately project the financial impact of Hurricanes Ike, Katrina and Rita. This experience highlights the limitations inherent in the use of modeling as a means of risk assessment/abatement. If the exposure amount and frequency of catastrophe losses are higher than predicted under NLASCO's modeling, NLASCO's financial condition may be materially adversely affected.

***NLASCO's investment performance has suffered, and may further suffer, as a result of adverse capital market developments and other factors, which affect its financial results.***

NLASCO invests the premiums it receives from policyholders until they are needed to pay policyholder claims or other expenses. At December 31, 2010, NLASCO's invested assets consisted of \$140.2 million in fixed maturity securities and \$8.8 million in equity securities. During the year ended December 31, 2010, NLASCO had \$5.9 million of net investment income, representing 4.5% of NLASCO's total revenues. Although NLASCO's investment policies stress diversification of risks, conservation of principal and liquidity, its investments are subject to a variety of investment risks, including those relating to general economic conditions, market volatility, interest rate fluctuations, liquidity risk and credit and default risk. In particular, the volatility of NLASCO's claims may force it to liquidate securities, which may cause it to incur capital losses. If NLASCO's investment portfolio is not appropriately matched with its insurance liabilities, it may be forced to liquidate investments prior to maturity at a significant loss to cover these liabilities. Investment losses could significantly decrease its asset base and statutory surplus, thereby adversely affecting its ability to conduct business and potentially its A.M. Best financial strength rating. Further, developments in the world's financial and capital markets have adversely impacted the performance of NLASCO's investments. Additionally, inflation could increase beyond investment income.

The capital and credit markets have been experiencing volatility and disruption for more than two years. This volatility and disruption has reached unprecedented levels, resulting in dramatic declines in prices. This downward pressure has negatively affected the performance of NLASCO's investments, which has resulted in the write down of several of those investments. These write-downs, when determined to be other-than-temporary, reduce NLASCO's earnings for that period. If current levels of market disruption and volatility continue or worsen, there can be no assurances that we will not experience additional losses on our investments and reductions in our earnings.

***NLASCO's investment results may be adversely affected by interest rate changes.***

NLASCO's operating results are affected, in part, by the performance of its investment portfolio. NLASCO's investment portfolio contains instruments, such as bonds, that may be adversely affected by increases in interest rates. Because bond trading prices decrease as interest rates rise, a significant increase in interest rates could have a material adverse effect on NLASCO's financial condition and results of operations. On the other hand, decreases in interest rates could have an adverse effect on NLASCO's investment income and results of operations. For example, if interest rates decline, investment of new premiums received and funds reinvested will earn less. Interest rates are highly sensitive to many factors, including governmental monetary policies, domestic and international economic and political conditions and other factors beyond NLASCO's control.

---

## [Table of Contents](#)

With respect to fixed-income investments, the fair market value of these securities fluctuates depending on market and other general economic conditions and the interest rate environment. Changes in interest rates can expose NLASCO to prepayment risks on these investments. When interest rates fall, mortgage-backed securities typically are prepaid more quickly and the holder must reinvest the proceeds at lower interest rates. NLASCO's mortgage-backed securities currently consist of securities with features that reduce the risk of prepayment, but NLASCO can make no assurances that it will invest in other mortgage-backed securities that contain this protection. In periods of increasing interest rates, mortgage-backed securities typically are prepaid more slowly, which may require NLASCO to receive interest payments that are below the then prevailing interest rates for longer time periods than expected.

***If NLASCO cannot price its business accurately, its profitability and the profitability of its insurance companies could be materially adversely affected.***

NLASCO's results of operations and financial condition depend on its ability to underwrite and set premium rates accurately for a wide variety of risks. Adequate rates are necessary to generate premiums sufficient to pay losses, loss adjustment expenses and underwriting expenses and to earn a profit. To price its products accurately, NLASCO must:

- collect and properly analyze a substantial amount of data;
- develop, test and apply appropriate pricing techniques;
- closely monitor and recognize changes in trends in a timely manner; and
- project both severity and frequency of losses with reasonable accuracy.

NLASCO's ability to undertake these efforts successfully, and price its products accurately, is subject to a number of risks and uncertainties, some of which are outside its control, including:

- the availability of sufficient reliable data and NLASCO's ability to properly analyze available data;
- changes in applicable legal liability standards and in the civil litigation system generally;
- NLASCO's selection and application of appropriate pricing techniques;
- NLASCO's ability to obtain regulatory approval, where necessary;
- the uncertainties that inherently characterize estimates and assumptions; and
- NLASCO's ability to obtain adequate premium rates to offset higher reinsurance costs.

Consequently, NLASCO could under-price risks, which would adversely affect its profit margins, or it could overprice risks, which could reduce its competitiveness and sales volume. In either case, its profitability and the profitability of its insurance companies could be materially adversely affected.

***If NLASCO's actual losses and loss adjustment expenses exceed its loss and expense estimates, its financial condition and results of operations could be materially adversely affected.***

NLASCO's financial condition and results of operations depend upon its ability to assess accurately the potential losses associated with the risks that it insures. NLASCO establishes reserve liabilities to cover the payment of all losses and loss adjustment expenses incurred under the policies that it writes. These liability estimates include case estimates, which are established for specific claims that have been reported to NLASCO, and liabilities for claims that have been incurred but not reported, or IBNR. Loss adjustment expenses represent expenses incurred to investigate and settle claims. To the extent that losses and loss adjustment expenses exceed estimates, NLIC and ASIC will be required to increase their reserve liabilities and reduce their income before income taxes in the period in which the deficiency is identified. In addition, increasing reserves causes a reduction in policyholders' surplus and could cause a downgrade in the ratings of NLIC and ASIC. This, in turn, could diminish its ability to sell insurance policies.

The liability estimation process for NLASCO's casualty insurance coverage possesses characteristics that make case and IBNR reserving inherently less susceptible to accurate actuarial estimation than is the case with property coverages. Unlike property losses, casualty losses are claims made by third-parties of which the policyholder may not be aware and, therefore, may be reported a significant time after the occurrence, including sometimes years later. As casualty claims most often involve claims of bodily injury, assessment of the proper case estimates is a far more subjective process than claims involving property damage. In addition, in determining the case estimate for a casualty claim, information develops slowly over the life of the claim and can subject the case estimation to substantial modification well after the claim was first reported. Numerous factors impact the casualty case reserving process, such as venue, the amount of monetary damage, legislative activity, the permanence of the injury and the age of the claimant.

---

## [Table of Contents](#)

The effects of inflation could cause the severity of claims from catastrophes or other events to rise in the future. Increases in the values and geographic concentrations of policyholder property and the effects of inflation have resulted in increased severity of industry losses in recent years, and NLASCO expects that these factors will increase the severity of losses in the future. As NLASCO observed in 2008, the severity of some catastrophic weather events, including the scope and extent of damage and the inability to gain access to damaged properties, and the ensuing shortages of labor and materials and resulting demand surge, provide additional challenges to estimating ultimate losses. NLASCO's liabilities for losses and loss adjustment expenses include assumptions about future payments for settlement of claims and claims handling expenses, such as medical treatments and litigation costs. To the extent inflation causes these costs to increase above liabilities established for these costs, NLASCO expects to be required to increase its liabilities, together with a corresponding reduction in its net income in the period in which the deficiency is identified.

Estimating an appropriate level of liabilities for losses and loss adjustment expense is an inherently uncertain process. Accordingly, actual loss and loss adjustment expenses paid will likely deviate, perhaps substantially, from the liability estimates reflected in NLASCO's consolidated financial statements. Claims could exceed NLASCO's estimate for liabilities for losses and loss adjustment expenses, which could have a material adverse effect on its financial condition and results of operations.

***If NLASCO cannot obtain adequate reinsurance protection for the risks it underwrites, NLASCO may be exposed to greater losses from these risks or may reduce the amount of business it underwrites, which may materially adversely affect its financial condition and results of operations.***

NLASCO uses reinsurance to protect itself from certain risks and to share certain risks it underwrites. During 2010 and 2009, NLASCO's personal lines ceded 16.0% and 16.2%, respectively, of its direct premiums written (primarily through excess of loss, quota share and catastrophe reinsurance treaties) and its commercial lines ceded 9.9% and 10.4%, respectively, of its direct premiums written (primarily through excess of loss and catastrophe reinsurance treaties). The total cost of reinsurance, inclusive of per risk excess and catastrophe, increased 6.2% in the year ended December 31, 2010, which is primarily attributable to two major catastrophes occurring in 2008. This includes additional catastrophe limits purchased. Reinsurance cost will likely materially increase, in part due to the frequency and severity of hurricanes and the lack of capacity in the reinsurance market.

From time to time, market conditions have limited, and in some cases have prevented, insurers from obtaining the types and amounts of reinsurance that they have considered adequate for their business needs. Accordingly, NLASCO may not be able to obtain desired amounts of reinsurance. Even if NLASCO is able to obtain adequate reinsurance, it may not be able to obtain it from entities with satisfactory creditworthiness



or negotiate terms that it deems appropriate or acceptable. Although the cost of reinsurance is, in some cases, reflected in NLASCO's premium rates, NLASCO may have guaranteed certain premium rates to its policyholders. Under these circumstances, if the cost of reinsurance were to increase with respect to policies for which NLASCO guaranteed the rates, NLASCO would be adversely affected. In addition, if NLASCO cannot obtain adequate reinsurance protection for the risks it underwrites, it may be exposed to greater losses from these risks or it may be forced to reduce the amount of business that it underwrites for such risks, which will reduce NLASCO's revenue and may have a material adverse effect on its results of operations and financial condition.

***NLASCO could face unanticipated losses from war, terrorism and political unrest, and these or other unanticipated losses could have a material adverse effect on NLASCO's financial condition and results of operations.***

NLASCO has exposure to unexpected losses resulting from future man-made catastrophic events, such as acts of terrorism and political instability. These risks are inherently unpredictable. It is difficult to predict the timing of such events with statistical certainty or to estimate the amount of loss that any given occurrence will generate. In certain instances, NLASCO specifically insures risks resulting from acts of terrorism. Even in cases where NLASCO attempts to exclude losses from terrorism and certain other similar risks from some coverage it writes, NLASCO may be prohibited from, or may not be successful in, doing so. Irrespective of the clarity and inclusiveness of policy language, a court or arbitration panel may limit the enforceability of policy language or otherwise issue a ruling adverse to NLASCO. Accordingly, while NLASCO believes that its reinsurance programs, together with the coverage provided under the Terrorism Risk Insurance Act of 2002, the Terrorism Risk Insurance Extension Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007, or, collectively, the Terrorism Act, are sufficient to reasonably limit its net losses relating to potential future terrorist attacks, its reserves may not be adequate to cover losses when they materialize. Under the Terrorism Act, after an act of terrorism is certified by the Secretary of the Treasury, NLASCO may be entitled to be reimbursed by the Federal government for a percentage of subject losses, after an insurer deductible and subject to an annual cap. The Terrorism Act covers an insurance company's operations for up to 85% of its losses, subject to certain mandatory deductibles. The deductible is calculated by applying the deductible percentage to the insurer's direct earned premiums for covered lines from the calendar year immediately prior to the applicable year. Although the Terrorism Act provides benefits in the event of certain acts of terrorism for losses in 2005 through 2014, the Terrorism Act may not be extended beyond 2014 or its benefits may be reduced. It is not

---

## [Table of Contents](#)

possible to completely eliminate NLASCO's exposure to unforecasted or unpredictable events, and to the extent that losses from such risks occur, NLASCO's financial condition and results of operations could be materially adversely affected.

***If NLASCO's reinsurers do not pay losses in a timely fashion, or at all, NLASCO may incur substantial losses that could materially adversely affect its financial condition and results of operations.***

At December 31, 2010, NLASCO had \$45.6 million in reinsurance recoverables, including ceded paid loss recoverables, ceded losses and loss adjustment expense recoverables and ceded unearned premiums. NLASCO expects to continue to purchase substantial reinsurance coverage in the foreseeable future. Since NLASCO remains primarily liable to its policyholders for the payment of their claims, regardless of the reinsurance it has purchased relating to those claims, in the event that one of its reinsurers becomes insolvent or otherwise refuses to reimburse NLASCO for losses paid, or delays in reimbursing NLASCO for losses paid, its liability for these claims could materially and adversely affect its financial condition and results of operations. As an example, if one of NLASCO's catastrophe reinsurers experienced financial difficulties following one of the major hurricanes in 2005 and had been unable to meet its obligations to NLASCO, NLASCO could have experienced difficulty in meeting its obligations to its policyholders.

***NLASCO relies on independent insurance agents to distribute its products, and if the agents do not promote NLASCO's products successfully, NLASCO's results of operations and financial condition could be adversely affected.***

NLASCO's business depends, in large part, on the efforts of independent insurance agents to market its insurance products and on its ability to offer insurance products and services that meet the requirements of their customers. While NLASCO strives to offer products that its agents require, NLASCO competes for business with other carriers based on the scope of coverage provided in its products, services, commissions and rates. NLASCO's competitors may offer coverage that is more attractive to particular customers than it offers for a specific product, may price their insurance products more aggressively, may offer higher agent commissions and may devote additional resources to improve their services. Accordingly, NLASCO's agents may find it easier to promote the programs of NLASCO's competitors rather than NLASCO's. If NLASCO's agents fail to, or choose not to, market NLASCO's insurance products successfully, NLASCO's growth may be limited and its financial condition and results of operations may be adversely affected. Additionally, rather than utilizing an independent agent to buy their insurance, consumers may elect to deal with direct-writers or mass marketers that utilize the Internet to advertise and/or underwrite their business. Industry developments that centralize and commoditize insurance products could be detrimental to NLASCO's agency distribution model of doing business.

***Because NLASCO relies on managing general agents to underwrite some of its products and to administer claims, such managing general agents could expose NLASCO to liability or allocate business away from NLASCO, which could cause NLASCO's financial condition and results of operations to be adversely affected.***

NLASCO has developed programs with managing general agents, or MGAs, whereby the MGA will, within the guidelines established by NLASCO, underwrite insurance policies on NLASCO's insurance subsidiaries' behalf with oversight by NLASCO. A MGA is a person, firm or corporation that has supervisory responsibility for the local agency and field operations of an insurer in the state where it is organized or that is authorized by an insurer to accept or process, on the insurer's behalf, insurance policies produced and sold by other agents. While NLASCO exercises care in the selection of its MGA relationships and regularly audits the performance of its MGAs, NLASCO is at risk for their conduct as a result of the authority it has delegated to them. If one of NLASCO's MGAs binds NLASCO's insurance subsidiaries to policies that expose it to

unexpected losses or fails to appropriately report claims, NLASCO's financial condition and results of operations could be adversely affected. For example, if a terminated MGA fails to continue to appropriately report claims during the runoff period, then liabilities for losses and loss adjustment expenses could be deficient, which would impact NLASCO's results of operations in future periods. Furthermore, subject to contractual limitations, MGAs have the ability to change carriers or increase or decrease the allocation to a particular carrier. A MGA might choose to change carriers or allocations for many reasons, such as pricing, service, conditions in the reinsurance market or a change in ownership of an MGA.

***A decline in NLIC's or ASIC's financial strength ratings by A.M. Best could cause either of their sales or earnings, or both, to decrease.***

Ratings have become an increasingly important factor in establishing the competitive position of insurance companies. A.M. Best maintains a letter scale rating system ranging from "A++ (Superior)" to "F (In Liquidation)" to rate the financial strength of insurance enterprises. NLIC has been rated "A (Excellent)" by A.M. Best, which is the third highest of sixteen rating levels. ASIC has been rated "A- (Excellent)" by A.M. Best, which is the fourth highest.

## [Table of Contents](#)

Each of NLIC's and ASIC's financial strength rating is subject to periodic review by, and may remain the same, be revised downward or upward or be revoked at the sole discretion of, A.M. Best. A decline in either NLIC's or ASIC's rating or an announced negative outlook on the rating can cause concern about their viability among agents, brokers and policyholders, resulting in a movement of business away from NLASCO and its insurance company subsidiaries to more highly-rated carriers. In addition, the errors and omissions insurance coverage of many of NLASCO's independent agents does not provide coverage if the covered agents sell policies from insurers with an A.M. Best financial strength rating of "B+ (Very Good)" or below. As a result, the loss of NLIC's or ASIC's A.M. Best financial strength rating, or a reduction to "B+ (Very Good)" or worse, may adversely impact NLASCO's ability to retain or expand its policyholder base. Periodically, A.M. Best changes its rating methodology and practices. Any change to the methodologies and practices could result in a reduction of NLIC's or ASIC's A.M. Best rating.

***The failure of any of the loss limitation methods NLASCO employs could have a material adverse effect on its financial condition and results of operations.***

At the present time, NLASCO employs a variety of endorsements to its policies that limit its exposure to known risks, such as exclusions for mold losses and water damage. NLASCO's policies also are not designed to provide coverage for claims related to exposure to potentially harmful products or substances, including, among others, lead paint and silica. NLASCO's homeowners' policies, other than policies specifically written for flood coverage, specifically exclude coverage for losses caused by flood, but generally provide coverage for damage caused by wind. In addition, NLASCO's policies contain conditions requiring the prompt reporting of claims and its right to decline coverage due to late claim reporting. NLASCO's policies also include limitations restricting the period during which a policyholder may bring a breach of contract or other claim against it, which in many cases is shorter than the applicable statutory limitations for such claims. It is possible that a court or regulatory authority could nullify or void, or legislation could be enacted modifying or barring, the use of endorsements and limitations in a way that would adversely affect NLASCO's loss experience, which could have a material adverse effect on its financial condition and results of operations.

***The effects of emerging claim and coverage issues on NLASCO's business are uncertain.***

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge. These issues may adversely affect NLASCO's business by either extending coverage beyond its underwriting intent or by increasing the number or size of claims. In some instances, these changes may not become apparent until long after NLASCO has issued insurance policies that are affected by the changes. As a result, the full extent of liability under NLASCO's insurance policies may not be known until after a contract is issued. Changes in other legal theories of liability under NLASCO's insurance policies or the failure of any loss limitation it applies also could adversely impact NLASCO's financial condition and results of operations.

***Because NLASCO's main source of premiums written is in Texas, unfavorable changes in the economic or regulatory environment in that state may have a material adverse effect on its financial condition and results of operations.***

Texas accounted for approximately 73.2% and 75.0% of NLASCO's direct premiums written in 2010 and 2009, respectively. The Texas legislature, in its 2011 legislative session, is reviewing insurance regulation, which will likely result in changes to those regulations. The loss of a significant amount of NLASCO's premiums written in Texas, whether due to an economic downturn, competitive changes, regulatory or legislative developments or other reasons, could have a material adverse effect on its financial condition and results of operations.

## [Table of Contents](#)

***If NLASCO is unsuccessful in competing against other competitors in the insurance industry, its financial condition and results of operations could be adversely affected.***

The insurance industry is highly competitive and has, historically, been characterized by periods of significant price competition, alternating with periods of greater pricing discipline during which competitors focus on other factors. In the current market environment, competition in NLASCO's industry is based primarily on the following:

- products offered;
- service;

- experience;
- the strength of agent and policyholder relationships;
- reputation;
- speed and accuracy of claims payment;
- perceived financial strength;
- ratings;
- scope of business;
- commissions paid; and
- policy and contract terms and conditions.

NLASCO competes with many other insurers, including large national companies who have greater financial, marketing and management resources than NLASCO. Many of these competitors also have better ratings and market recognition than NLASCO. NLASCO seeks to distinguish itself from its competitors by providing a broad product line and targeting those market segments that provide the best opportunity to earn an underwriting profit.

NLASCO also faces competition from entities that self-insure, primarily in the commercial insurance market. From time to time, established and potential customers may examine the benefits and risks of self-insurance and other alternatives to traditional insurance.

In addition, a number of new, proposed or potential industry developments also could increase competition in NLASCO's industry. These developments include, but are not necessarily limited to, changes in practices and other effects caused by the Internet (including direct marketing campaigns by NLASCO's competitors in established and new geographic markets), which have led to greater competition in the insurance business and increased expectations for customer service. These developments could prevent NLASCO from expanding its book of business.

NLASCO also faces competition from new entrants into the insurance market. New entrants do not have historic claims or losses to address and, therefore, may be able to price policies on a basis that is not favorable to NLASCO. New competition could reduce the demand for NLASCO's insurance products, which could have a material adverse effect on its financial condition and results of operations.

***The debt agreements of NLASCO and its controlled affiliates contain financial covenants and impose restrictions on its business.***

The indenture governing NLASCO's LIBOR plus 3.40% notes due 2035 contains restrictions on its ability to, among other things, declare and pay dividends and merge or consolidate. In addition, this indenture contains a change of control provision, which provides that (i) if a person or group becomes the beneficial owner, directly or indirectly, of 50% or more of NLASCO's equity securities and (ii) if NLASCO's ratings are downgraded by a nationally recognized statistical rating organization (as defined in the Securities Exchange Act of 1934), then each holder of the notes governed by such indenture has the right to require that NLASCO purchase such holder's notes, in whole or in part, at a price equal to 100% of the then outstanding principal amount.

The surplus indentures governing NLIC's LIBOR plus 4.10% notes due 2033 and ASIC's LIBOR plus 4.05% notes due 2034 contain restrictions on dividends and mergers and consolidations. In addition, NLASCO has other credit arrangements with its affiliates and other third-parties.

---

[Table of Contents](#)

NLASCO's ability to comply with these covenants may be affected by events beyond its control, including prevailing economic, financial and industry conditions. The breach of any of these restrictions could result in a default under the loan agreements or indentures governing the notes or under its other debt agreements. An event of default under its debt agreements would permit some of its lenders to declare all amounts borrowed from them to be due and payable, together with accrued and unpaid interest. If NLASCO were unable to repay debt to its secured lenders, these lenders could proceed against the collateral securing that debt. In addition, acceleration of its other indebtedness may cause NLASCO to be unable to make interest payments on the notes.

Other agreements that NLASCO or its insurance company subsidiaries may enter into in the future may contain covenants imposing significant restrictions on their respective businesses that are similar to, or in addition to, the covenants under their respective existing agreements. These restrictions may affect NLASCO's ability to operate its business and may limit its ability to take advantage of potential business opportunities as they arise.

***The regulatory system under which NLIC and ASIC operate, and potential changes to that system, could have a material adverse effect on their respective business activities.***

NLIC and ASIC are subject to comprehensive regulation and supervision in those states in which they are domiciled and write insurance policies. Though NLIC and ASIC currently write most of their policies in Texas, Arizona, Tennessee, Oklahoma, Georgia and Louisiana, as of December 31, 2010, NLIC is licensed in 23 states and ASIC is licensed in 35 states. Laws and regulations pertaining to NLIC and ASIC are generally administered by state insurance departments and relate to, among other things:

- standards of solvency, including risk-based capital measurements;
- restrictions on the nature, quality and concentration of investments;
- required methods of accounting;
- rate and policy form regulation and other market conduct; and
- potential assessments for the provision of funds necessary for covered claims under certain policies provided by impaired, insolvent

or failed insurance companies.

These state insurance departments also conduct periodic examinations of insurance companies and require the filing of annual and other reports relating to financial condition, holding company issues and other matters. Current or future regulatory requirements may adversely affect or inhibit each of the insurance company's ability to achieve some or all of its business objectives.

NLIC and ASIC may not be able to obtain or maintain necessary licenses, permits, authorizations or accreditations in states where they are currently licensed or in new states they intend to enter, or they may be able to do so only at a significant cost. In addition, they may not be able to comply fully with, or obtain appropriate exemptions from, the wide variety of laws and regulations applicable to insurance companies and insurance holding companies, which could result in restrictions on their operating flexibility and could subject them to fines and other sanctions that may have a material adverse effect on their business.

Significant changes in the political and regulatory climate could result in changes in applicable laws and regulations and could make it more expensive or less profitable to manage their business. In recent years, the United States insurance regulatory framework has come under increased federal scrutiny, and some state legislators have considered, or enacted, laws that may alter or increase state regulation of insurance and reinsurance companies and holding companies. Moreover, the National Association of Insurance Commissioners, or NAIC, and state insurance regulators regularly reexamine existing laws and regulations and develop new laws. For instance, the Texas legislature, in its 2011 legislative session, is reviewing insurance regulation, which will likely result in changes to those regulations. Changes in laws and regulations, or their interpretation, could have a material adverse effect on the insurance companies' financial condition and results of operations.

The activities of the insurance companies' MGAs are subject to licensing requirements and regulation under the laws of the states in which they operate. The insurance companies' MGAs' businesses depend on the validity of, and continued good standing under, the licenses and approvals pursuant to which they operate, as well as compliance with pertinent laws and regulations.

---

## [Table of Contents](#)

Company licensing laws and regulations vary from jurisdiction to jurisdiction. In all jurisdictions, the applicable company licensing laws and regulations are subject to amendment or interpretation by regulatory authorities. Generally, these authorities are vested with relatively broad discretion to grant, renew and revoke licenses and approvals for various reasons, including the violation of law and conviction of crimes. Other sanctions may include the suspension of individual employees, limitations on engaging in a particular business for specified periods of time, revocation of licenses, censures, redress to policyholders and fines. Although NLASCO and its insurance subsidiaries endeavor to follow practices based on good faith interpretations of laws and regulations, or those generally followed by the industry, these practices may prove to be different from those that the regulatory authorities require.

***If the states in which NLIC and ASIC write insurance increase the assessments that insurance companies are required to pay, NLASCO's and their financial condition and results of operations will suffer.***

NLIC and ASIC are subject to a variety of taxes, fines, levies, license fees, tariffs and other assessments that may, from time to time, be material. These assessments are made by the states in which NLIC and ASIC operate and include participation in residual market or involuntary risk plans in various states that provide insurance coverage to individuals or entities that otherwise are unable to purchase such coverage from private insurers. Due to this participation, NLIC and ASIC may be exposed to material losses. They also are subject to assessments in the states in which they write insurance for various purposes, including the provision of funds necessary to fund the operations of various insurance guaranty associations, which pay covered claims under certain policies issued by impaired, insolvent or failed insurance companies. These assessments are generally set based on an insurer's percentage of the total premiums written in the relevant state within a particular line of business for the relevant time period. For the years ended December 31, 2010 and 2009, NLASCO paid no assessments. For the year ended December 31, 2008, NLIC and ASIC, collectively, paid \$1.3 million in assessments related to Hurricanes Dolly and Ike. If NLIC's and ASIC's total premiums written grow, NLASCO's share of any assessments may increase, as well. NLASCO, however, cannot predict with certainty the amount of future assessments, because these assessments depend on factors outside NLASCO's control, such as the insolvencies of other insurance companies, the market shares of other insurance companies writing in a particular state and the degree to which other companies write in coastal areas.

NLASCO is subject to assessments from the Georgia Underwriting Association, Louisiana Citizens Property Insurance Corporation, or LCPIC, Mississippi Windstorm Underwriting Association, or MWUA, the Texas FAIR Plan Association and the Texas Windstorm Insurance Association, or TWIA.

LCPIC, MWUA and TWIA have estimated plan losses from the hurricanes that struck Louisiana and Texas in the third quarter of 2005, and are thereby able to levy regular and emergency assessments to participating companies and policyholders, respectively. NLASCO does not expect that these assessments will have a net financial statement impact, as all these assessments are recoverable (subject to treaty limits) under its reinsurance treaties. Further, NLASCO may be able to recoup a regular assessment through a surcharge to policyholders. These recoupments will be refunded to reinsurers as the related premiums are written and collected. NLASCO is required to collect emergency assessments directly from residential property policyholders and remit them to LCPIC as they are collected.

NLASCO continues to monitor developments with respect to various state facilities, such as the Georgia Underwriting Association, LCPIC, MWUA, the Texas FAIR Plan Association and the TWIA. The ultimate impact of Hurricanes Katrina, Rita, Dolly and Ike on these facilities is currently uncertain, but could result in the facilities recognizing a financial deficit different than the level currently estimated. They may, in turn, have the ability to assess participating insurers when financial deficits occur. NLASCO will not, however, incur any net expense or loss from any of these assessments due to reinsurance recoveries.

***NLASCO may be subject to high retaliatory taxes in several states as a result of its multistate operations, which could have a material***



*adverse impact on its financial condition and results of operations.*

Nearly all states impose a retaliatory tax on insurers operating in their state that are domiciled in another state. Retaliatory taxes are based on the principle that if the aggregate taxes, fees and obligations imposed by an insurer's domiciliary state are greater than the aggregate taxes, fees and obligations imposed by the taxing state, then the difference is payable to the taxing state as a retaliatory tax. For example, the State of Texas imposes various premium-based taxes that, in the aggregate, total approximately 2.0% of gross written premiums in Texas. The State of Illinois imposes various premium-based taxes that, in the aggregate, total approximately 0.5% of gross written premiums in Illinois. The Illinois retaliatory tax provisions would require a Texas-domiciled insurer operating in Illinois to pay the 0.5% aggregate Illinois taxes plus a 1.5% incremental amount, which represents the difference between the Texas effective rate and the Illinois effective rate. Thus, a Texas-domiciled insurer would pay a 2.0% effective tax in Illinois, while an Illinois-domiciled insurer would only pay a 0.5% effective tax. Insurance companies with multistate operations, like NLASCO, may find themselves subject to high retaliatory taxes in several states, which could have a material adverse impact on NLASCO's financial condition and results of operations.

---

[Table of Contents](#)

***NLASCO's ability to meet ongoing cash requirements and pay dividends may be limited by its holding company structure and regulatory constraints.***

NLASCO operates as a holding company. Dividends and other permitted payments from its operating subsidiaries are expected to be its primary source of funds to meet ongoing cash requirements, including any future debt service payments and other expenses, and to pay dividends, if any, to Hilltop. NLIC and ASIC are subject to significant regulatory restrictions and limitations under debt agreements limiting their ability to declare and pay dividends, which could, in turn, limit NLASCO's ability to meet its ongoing cash requirements, including any future debt service payments and other expenses, or to pay dividends.

***Current legal and regulatory activities, investigations, litigation proceedings or other activities relating to the insurance industry could affect NLASCO's business, financial condition and results of operations.***

The insurance industry has experienced share price volatility as a result of litigation, investigations and regulatory activity by various insurance, governmental and enforcement authorities concerning certain practices within the insurance industry. NLASCO is unable to predict the potential effects, if any, that these investigations may have upon the insurance markets and industry business practices in general or what, if any, changes may be made to laws and regulations regarding the industry and financial reporting. Any of the foregoing could materially and adversely affect its business, financial condition and results of operations.

***NLIC and ASIC are subject to periodic financial and market conduct examinations by state insurance departments. If these examinations identify significant findings or recommend significant changes to its operations, either insurance company could lose its licenses or its financial condition and results of operations could be affected.***

The insurance departments in every state in which NLASCO's insurance companies do business may conduct on-site visits and examinations at any time and generally for any purpose, including the review of NLASCO's insurance companies' financial condition, market conduct and relationships and transactions with affiliates. In addition, the Texas Department of Insurance will conduct comprehensive examinations of NLASCO's insurance companies every three to five years. NLASCO is scheduled to be examined in 2011 for prior years. NLIC's last completed regulatory exam was a full scope financial examination by the Texas Department of Insurance covering the period from January 1, 2002 through December 31, 2006, including material transactions and/or events occurring after December 31, 2006. ASIC's last completed regulatory exam was a full scope financial examination by the Texas Department of Insurance covering the period from January 1, 2004 through December 31, 2006, including certain material transactions and/or events occurring after December 31, 2006. Neither examination resulted in any significant regulatory compliance issues being raised by the Texas Department of Insurance. NLASCO and its insurance subsidiaries, however, have paid fines related to market conduct examinations by various states. Fines incurred in the last three years did not have a material impact on its financial condition or results of operations.

While there were no material adverse findings or recommended changes to NLASCO's or its insurance company subsidiaries' operations identified in the last completed financial examinations conducted by the departments of insurance, there can be no assurance that there will not be adverse findings or recommended changes identified by these or other state insurance departments in the scheduled examination or the future. In addition, significant adverse findings could lead to a revocation of NLASCO's or its insurance company subsidiaries' licenses. Any adverse findings or recommended changes resulting from such financial examinations, or from any future examinations, could have a material adverse effect on NLASCO's or its insurance company subsidiaries' financial condition and results of operations.

***Departure of key personnel would deprive us of the institutional knowledge, expertise and leadership they provide.***

Operating an insurance company is complex. The insurance industry is highly competitive and has historically been characterized by periods of significant price competition, alternating with periods of greater pricing discipline during which competitors focus on other factors. In addition, insurance companies are subject to comprehensive regulation and supervision in those states in which they write insurance policies and in which they are domiciled. Significant changes in the political and regulatory climate could result in changes in these laws and regulations and could make it more expensive or less profitable for us to manage an insurance company. The loss of key personnel may result in us encountering difficulties in operating an insurance company and complying with regulatory requirements applicable to insurance companies.



***NLASCO is in the process of implementing a new information technology system that could cause substantial business interruption.***

We are in the process of designing and implementing a new information technology system and are investing significant financial and personnel resources into this project. There is no assurance, however, that the design will meet our current and future business needs or that it will operate as designed. We are heavily dependent on computer systems, and any significant failure or delay in the system implementation, if encountered, would cause a substantial interruption to our business and additional expense that could result in an adverse impact on our operating results, cash flows and financial condition.

***Failures in NLASCO's current electronic underwriting system could adversely affect its financial condition and results of operations.***

NLASCO's Internet-based Policy Agency Claim System, or PACS, was primarily developed in-house. PACS is fully integrated and is able to process quotes, policy issuance, billings, payments and claims. The system is designed for ease of use by agents and employees. PACS has been an integral part of NLASCO's success. Almost all applications are submitted online. Problems or errors of which NLASCO is not currently aware may have occurred in connection with the installation, upgrading or maintenance of this system or any of its other systems or may result from a major physical disaster or other calamity that causes damage to NLASCO's systems generally. A loss of PACS or any of NLASCO's other systems for a sustained period of time could have an adverse impact on its financial condition and results of operations.

***Failure to develop an adequate knowledge transfer or a succession plan for NLASCO's information technology personnel could adversely affect its financial condition and results of operations.***

The success of PACS and NLASCO's new and other systems depend heavily on the incumbent information technology team that developed or implemented the system. A loss of key members of this team without adequate knowledge transfer or a succession plan could disrupt NLASCO's operations and adversely affect its results of operations.

***Claims by third-parties that NLASCO infringes their proprietary technology could adversely affect NLASCO's financial condition and results of operations.***

If NLASCO discovers that any of its products, or technology that it licenses from third-parties, violates third-party proprietary rights, NLASCO may not be able to reengineer its products or obtain a license on commercially reasonable terms to continue using the products or technology without substantial reengineering, or to otherwise modify programs. In addition, product and technology development is inherently uncertain in a rapidly evolving technology environment in which there may be numerous patent applications pending for similar technologies, many of which are confidential when filed. In addition, much of the software used by NLASCO may be used subject to a licensing agreement, and NLASCO's failure to comply with the terms for usage under any such licensing agreement could subject it to claims that could adversely impact its business. Although NLASCO sometimes may be indemnified by third-parties against claims that licensed third-party technology infringes proprietary rights of others, this indemnity may be limited, unavailable or, where the third party lacks sufficient assets or insurance, ineffective. NLASCO currently does not have liability insurance to protect against the risk that its technology or future licensed third-party technology infringes the proprietary rights of others. Any claim of infringement, even if invalid, could cause NLASCO to incur substantial costs defending against the claim and could distract its management from the business. Furthermore, a party making such a claim could secure a judgment that requires NLASCO to pay substantial damages. A judgment also could include an injunction or other court order that could prevent NLASCO from using the products and technologies. Any of these events could have a material adverse effect on NLASCO's business, operating results and financial condition.

***Acquisitions could result in operating difficulties and other harmful consequences.***

From time to time, NLASCO may engage in discussions regarding potential acquisitions, including potential acquisitions that could be material to its financial condition and results of operations. NLASCO may acquire whole businesses or books of business that fit its underwriting competencies from insurance companies, MGAs and other agents. In addition, NLASCO may expand its business, product offerings and policyholder base by acquiring businesses in areas in which NLASCO has limited operating experience. The process of integrating an acquired company or book of business may create unforeseen operating difficulties and expenditures. In particular:

- NLASCO has achieved its prior success by applying a disciplined approach to underwriting and pricing in select markets that are not well served by its competitors. NLASCO may not be able to successfully implement its underwriting, claims management, pricing and product strategies in companies or books of business it acquires;

- NLASCO may not be able to retain the agents associated with acquired businesses and, as a result, may fail to realize the anticipated potential benefits of the acquisition;
- NLASCO could be required to implement or remediate controls, procedures and policies for an acquired privately-held company that prior to acquisition may not have been required;
- An acquisition could present cultural challenges associated with integrating employees from the acquired company into the organization, which could result in a loss of employees from the businesses NLASCO acquires and other adverse consequences;
- NLASCO's management may have to divert its time and energy from operating the business to integration challenges;
- NLASCO could have no prior experience operating the type of business that it acquires, which could create difficulties and result in NLASCO failing to realize many of the anticipated potential benefits of the acquisition; and

- An acquisition could dilute NLASCO's book value per share or after-tax return on average equity.

The anticipated benefits of any acquisition may not materialize. Future acquisitions could result in the incurrence of debt or an assumption of inadequate liabilities for losses and loss adjusted expenses or claims management structures, any of which could harm NLASCO's financial condition. Future acquisitions may require NLASCO to obtain additional financing, which may not be available on favorable terms or at all.

## **Risks Related to the Securities Markets and Ownership of Our Common Stock**

*Our charter and insurance laws contain provisions that could discourage acquisition bids or merger proposals, which may adversely affect the market price of our common stock.*

**Ownership Limit.** In order to reduce the risk of an ownership change in the future, our charter restricts certain acquisitions of our securities in order to preserve the benefit of our NOLs. The charter generally prohibits any direct or indirect sale, transfer, assignment, conveyance, pledge or other disposition of shares of our stock or warrants, rights or options to purchase our stock or any other interests that would be treated as our stock under the income tax regulations promulgated under the Internal Revenue Code of 1986, as amended, if as a result of such sale, transfer, assignment, conveyance, pledge or other disposition any person or group would beneficially own five percent or more of the market value of the total outstanding shares of our common stock or the percentage of our common stock owned by a five percent or greater stockholder would be increased. Beneficial ownership is determined utilizing Treasury Regulation Section 1.382-2T(g). The transfer restrictions were implemented in January 2007, and we expect to maintain these provisions for the foreseeable future. We cannot assure you, however, that these restrictions will prevent an ownership change. If any of our stockholders increase their beneficial ownership percentage in our common stock through future acquisitions, there is an increased possibility that the provisions under the charter may be triggered. Any attempted transfer of shares in violation of the charter prohibitions will be void, and the intended transferee will not acquire any right in those shares. We have the right to take any lawful action that we believe is necessary or advisable to ensure compliance with these ownership and transfer restrictions, including refusing to recognize any transfer of stock in violation of our charter. These ownership and transfer restrictions of our charter may have the effect of discouraging or preventing a third party from attempting to gain control of us without the approval of our board of directors. Accordingly, it is less likely that a change in control, even if beneficial to stockholders, could be effected without the approval of our board of directors.

**Authority to Issue Additional Shares.** Under our charter, our board of directors may issue up to an aggregate of ten million shares of preferred stock without stockholder action. The preferred stock may be issued, in one or more series, with the preferences and other terms designated by our board of directors that may delay or prevent a change in control of us, even if the change is in the best interests of stockholders. As of December 31, 2010, no shares of preferred stock were designated or outstanding.

**Insurance Laws.** NLIC and ASIC are domiciled in the State of Texas. Before a person can acquire control of an insurance company domiciled in Texas, prior written approval must be obtained from the Texas Department of Insurance. Acquisition of control would be presumed on the acquisition, directly or indirectly, of ten percent or more of Hilltop's outstanding voting stock, unless the regulators determine otherwise. Prior to granting approval of an application to acquire control of a domestic insurer, the Texas Department of Insurance will consider several factors, such as:

- the financial strength of the acquirer;
- the integrity and management experience of the acquirer's board of directors and executive officers;
- the acquirer's plans for the management of the insurer;

---

## Table of Contents

- the acquirer's plans to declare dividends, sell assets or incur debt;
- the acquirer's plans for the future operations of the domestic insurer;
- the impact of the acquisition on continued licensure of the domestic insurer;
- the impact on the interests of Texas policyholders; and
- any anti-competitive results that may arise from the consummation of the acquisition of control.

These laws may discourage potential acquisition proposals of Hilltop and may delay, deter or prevent a change of control of Hilltop, including transactions that some or all of our stockholders might consider desirable.

*Future issuances of shares of common stock may adversely affect the price of our common stock.*

The future issuance of a substantial number of shares of common stock into the public market, or the perception that such issuance could occur, could adversely affect the prevailing market price of our common stock. A decline in the price of our common stock could make it more difficult to raise funds through future offerings of our common stock or securities convertible into common stock.

*Our common stock price may experience substantial volatility, which may affect your ability to sell our common stock at an advantageous price.*

Price volatility of our common stock may affect your ability to sell our common stock at an advantageous price. Market price fluctuations in our common stock may arise due to acquisitions, dispositions or other material public announcements, including those regarding dividends or changes in management, along with a variety of additional factors, including, without limitation, other risks identified in "Forward-looking Statements" and these "Risk Factors." In addition, the stock markets in general, including the NYSE, have experienced extreme price and trading fluctuations. These fluctuations have resulted in volatility in the market prices of securities that often have been unrelated or disproportionate to

changes in operating performance. These broad market fluctuations may adversely affect the market price of our common stock.

***Our rights and the rights of our stockholders to take action against our directors and officers are limited.***

We are organized under Maryland law, which provides that a director or officer has no liability in that capacity if he or she performs his or her duties in good faith, in a manner he or she reasonably believes to be in our best interests and with the care that an ordinarily prudent person in a like position would use under similar circumstances. In addition, our charter eliminates our directors' and officers' liability to us and our stockholders for money damages, except for liability resulting from actual receipt of an improper benefit or profit in money, property or services or active and deliberate dishonesty established by a final judgment and that is material to the cause of action. Our bylaws require us to indemnify our directors and officers for liability resulting from actions taken by them in those capacities to the maximum extent permitted by Maryland law. As a result, our stockholders and we may have more limited rights against our directors and officers than might otherwise exist under common law. In addition, we may be obligated to fund the defense costs incurred by our directors and officers.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

Not applicable.

**ITEM 3. LEGAL PROCEEDINGS**

We are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows taken as a whole.

**ITEM 4. RESERVED**

[Table of Contents](#)

**PART II**

**ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

**Securities, Stockholder and Dividend Information**

Our common stock is listed on the New York Stock Exchange under the symbol "HTH". Our common stock has no public trading history prior to February 12, 2004. The initial public offering price of our common stock on February 12, 2004 was \$19.00 per share. Our common stock closed at \$9.25 on March 10, 2011. As of March 11, 2011, there were 56,496,619 shares of our common stock outstanding with approximately 175 stockholders of record.

Prior to full redemption of our Series A Cumulative Redeemable Preferred Stock on September 6, 2010, it was listed on the New York Stock Exchange under the symbol "HTHPRA". Our Series A preferred stock has no public trading history prior to February 12, 2004.

We have not paid, and do not intend to pay in the foreseeable future, cash dividends on our common stock. Any declaration of dividends on our common stock will be at the discretion of our Board of Directors and will depend on the earnings, financial condition, capital requirements, contractual restrictions with respect to payment of dividends and other factors. See Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources — Restrictions on Dividends and Distributions."

The following table sets forth the cash dividends declared and paid in 2010 and 2009 with respect to our Series A Preferred Stock:

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
<b>Series A Preferred Stock</b>				
<b>2010</b>				
Date of declaration	March 17, 2010	July 8, 2010	August 6, 2010	N/A
Date of record	April 15, 2010	July 15, 2010	September 6, 2010	N/A
Date paid	April 30, 2010	July 30, 2010	September 6, 2010	N/A
Distribution per unit	\$ 0.5156	\$ 0.5156	\$ 0.2063	N/A
Total dollars (in thousands)	\$ 2,578	\$ 2,578	\$ 1,032	N/A
<b>2009</b>				
Date of declaration	March 16, 2009	July 6, 2009	September 15, 2009	December 10, 2009
Date of record	April 15, 2009	July 15, 2009	October 15, 2009	January 15, 2010
Date paid	April 30, 2009	July 30, 2009	October 30, 2009	January 29, 2010
Distribution per unit	\$ 0.5156	\$ 0.5156	\$ 0.5156	\$ 0.5156
Total dollars (in thousands)	\$ 2,578	\$ 2,578	\$ 2,578	\$ 2,579

[Table of Contents](#)

The following table discloses the high and low sales prices per quarter for our common and preferred stock during 2010 and 2009:

	Common Stock		Series A Preferred Stock	
	High	Low	High	Low
<b>December 31, 2010</b>				
First Quarter	\$ 12.41	\$ 11.29	\$ 25.86	\$ 24.48
Second Quarter	\$ 12.20	\$ 9.90	\$ 26.58	\$ 24.90
Third Quarter	\$ 10.77	\$ 9.31	\$ 26.70	\$ 25.08
Fourth Quarter	\$ 10.52	\$ 9.47	N/A	N/A
<b>December 31, 2009</b>				
First Quarter	\$ 11.95	\$ 8.93	\$ 21.25	\$ 16.20
Second Quarter	\$ 12.53	\$ 10.87	\$ 23.59	\$ 17.39
Third Quarter	\$ 12.98	\$ 11.20	\$ 24.46	\$ 22.50
Fourth Quarter	\$ 12.95	\$ 11.25	\$ 25.84	\$ 23.25

As of December 31, 2010, we had no warrants outstanding.

**Issuances of Unregistered Securities**

All issuances of unregistered securities have previously been reported.

**Equity Compensation Plan Information**

The following table sets forth as of December 31, 2010, information concerning our equity compensation plans, including the number of shares issuable and available for issuances under our plans, options, warrants and rights; weighted average exercise price of outstanding options, warrants and rights; and the number of securities remaining available for future issuance.

**Equity Compensation Plan Information**

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in first column)
Equity compensation plans approved by security holders*	100,000	\$ 12.06	1,029,249
Equity compensation plans not approved by security holders	—	—	—
<b>Total</b>	<b>100,000</b>	<b>\$ 12.06</b>	<b>1,029,249</b>

\*Excludes shares of restricted stock granted, as all of these shares are vested. No exercise price is required to be paid upon the vesting of the restricted shares of common stock granted. These shares are issuable under our 2003 equity incentive plan, which provides for the grant of equity-based incentives, including restricted shares of our common stock, stock options, grants of shares and other equity-based awards, to our directors, officers and other employees and those of our subsidiaries selected by our Compensation Committee for participation in the plan. At inception, 1,992,387 shares were authorized for grant pursuant to this plan. All shares outstanding, whether vested or unvested, are entitled to receive dividends and to vote, unless forfeited. No participant in our 2003 equity incentive plan may be granted awards in any fiscal year covering more than 500,000 shares of our common stock.

[Table of Contents](#)**ITEM 6. SELECTED FINANCIAL AND OPERATING DATA**

Our historical consolidated balance sheet data as of December 31, 2010 and 2009 and our consolidated statement of operations data for the

years ended December 31, 2010, 2009 and 2008 have been derived from our audited historical financial statements included elsewhere in this Form 10-K. The following table shows our selected historical financial data for the periods indicated (in thousands, except per share data). You should read our selected historical financial data, together with the notes thereto, in conjunction with the more detailed information contained in our financial statements and related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included in this Form 10-K.

	Year Ended December 31,				
	2010	2009	2008	2007	2006
<b>Income Statement Data:</b>					
Direct premium written	\$ 139,290	\$ 131,309	\$ 132,642	\$ 122,708	\$ —
Net premium written	121,691	114,743	113,285	118,357	—
Net premium earned	117,192	115,153	115,247	96,804	—
Net investment income	7,664	6,458	27,143	24,829	2,133
Net realized gain (loss)	137	307	(45,992)	3,205	—
Other income, net	6,744	6,917	6,147	6,445	—
Total revenue	<u>131,737</u>	<u>128,835</u>	<u>102,545</u>	<u>131,283</u>	<u>2,133</u>
Net loss and loss adjustment expense	70,943	70,295	80,435	52,074	—
Policy acquisition and other expense	53,378	52,333	53,726	42,397	7,477
Interest expense	8,971	9,668	10,528	11,539	7,436
Total expenses	<u>133,292</u>	<u>132,296</u>	<u>144,689</u>	<u>106,010</u>	<u>14,913</u>
(Loss) Income from continuing operations before federal income tax expense	(1,555)	(3,461)	(42,144)	25,273	(12,780)
Federal income taxes benefit (expense) for continuing operations	1,007	1,349	19,559	(10,635)	—
Net (loss) income from continuing operations before allocation of non-controlling interest	<u>\$ (548)</u>	<u>\$ (2,112)</u>	<u>\$ (22,585)</u>	<u>\$ 14,638</u>	<u>\$ (12,780)</u>
<b>Selected Balance Sheet Data:</b>					
Total investments	148,965	129,968	138,568	191,024	—
Total assets	939,641	1,040,752	1,048,770	1,085,491	1,542,701
Total liabilities	286,586	256,975	257,315	261,306	1,095,323
Stockholders’ equity	653,055	783,777	791,455	824,185	419,236
<b>Other Data:</b>					
Net loss and LAE ratio	60.5%	61.0%	69.8%	53.8%	n/a
Expense ratio	36.0%	35.7%	35.6%	29.2%	n/a
GAAP Combined ratio	96.5%	96.8%	105.4%	83.0%	n/a
Statutory surplus	\$ 119,297	\$ 117,063	\$ 108,478	\$ 124,892	n/a
Statutory premiums to surplus ratio	102.0%	98.0%	104.4%	94.8%	n/a
<b>Per Share Data:</b>					
Basic (loss) earnings per share attributable to common stockholders	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>	<u>\$ 5.10</u>	<u>\$ (0.63)</u>
Diluted (loss) earnings per share attributable to common stockholders	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>	<u>\$ 5.02</u>	<u>\$ (0.63)</u>
<b>Weighted average share information</b>					
Basic shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>	<u>55,421</u>	<u>43,681</u>
Diluted shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>	<u>56,326</u>	<u>43,681</u>
<b>Cash dividends declared per share of unit:</b>					
Series A preferred stock dividends	<u>\$ 1.24</u>	<u>\$ 2.06</u>	<u>\$ 2.06</u>	<u>\$ 2.06</u>	<u>\$ 2.06</u>
Series B preferred unit distributions	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>
Series C preferred unit distributions	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1.56</u>
Common stock and OP unit dividends	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 0.50</u>

- (1) Series A preferred unit distributions were redeemed in September 2010.
- (2) Series B and C preferred unit distributions were redeemed in 2007.
- (3) All years have been adjusted to reflect the disposal of our manufactured home community properties and related business, except for NLASCO.
- (4) Statutory surplus includes combined surplus of NLIC and ASIC



elsewhere in this Form 10-K and the financial information set forth in the tables below. All dollar amounts in the following discussion are in thousands, except per share amounts.

Unless the context otherwise indicates, all references in this Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, to the "Company," "Hilltop," "HTH," "we," "us," "our" or "ours" or similar words are to Hilltop Holdings Inc. (formerly known as Affordable Residential Communities Inc.) and its direct and indirect wholly-owned subsidiaries.

## OUR GENERAL STRUCTURE

At December 31, 2010, HTH is a holding company that owns all of the outstanding shares of NLASCO, Inc., or NLASCO. NLASCO, in turn, owns National Lloyds Insurance Company, or NLIC, and American Summit Insurance Company, or ASIC, both of which are licensed property and casualty insurers operating in multiple states. In addition, NLASCO also owns the NALICO GA, a general agency that operates in Texas. NLIC commenced business in 1949 and currently operates in 15 states, with its largest market being the state of Texas. NLIC carries a financial strength rating of "A" (Excellent) by A.M. Best. ASIC was formed in 1955 and currently operates in 12 states, its largest market being the state of Arizona. ASIC carries a financial strength rating of "A" (Excellent) by A.M. Best. Both of these companies are regulated by the Texas Department of Insurance.

Beginning in 1995, we were founded as several companies under the name "Affordable Residential Communities" or "ARC," now known as Hilltop Holdings Inc., for the purpose of engaging in the business of acquiring, renovating, repositioning and operating manufactured home communities, as well as certain related businesses. In 1998 we formed a Maryland corporation for the purpose of acting as the investment vehicle for, and a co-general partner of, our operating partnership, HTH Operating Partnership LP, formerly known as Affordable Residential Communities LP. In May 2002, we completed a reorganization in which we acquired substantially all the other real property partnerships and other related businesses we had previously organized and operated.

Through the year ended December 31, 2005, we were organized as a fully-integrated, self-administered and self-managed equity real estate investment trust, or REIT, for U.S. Federal income tax purposes. In 2006, we revoked our election as a REIT for U. S. Federal income tax purposes.

In January 2007, we acquired NLASCO. NLASCO was incorporated in Delaware in 2000 but its origins trace back to 1948 through one of its subsidiaries, NLIC. In 1964, C. Clifton Robinson, who is currently the Chairman of NLASCO and a member of our Board of Directors, along with other investors, purchased NLIC and moved its headquarters from San Antonio, Texas to Waco, Texas. Following various acquisitions and dispositions of equity in NLIC by Mr. Robinson and others, including the re-acquisition of NLIC along with the acquisition of ASIC in 2000, Mr. Robinson held 100% of NLASCO and its subsidiaries, NLIC and ASIC, from 2001 until we acquired NLASCO in 2007.

On July 31, 2007, we sold substantially all of the operating assets used in our manufactured home communities business and our retail sales and financing business to American Residential Communities LLC. We received gross proceeds of approximately \$890 million in cash, which represents the aggregate purchase price of \$1.794 billion, less the indebtedness assumed by the buyer. After giving effect to expenses, taxes and our continued outstanding preferred stock and senior notes, our net cash balance was approximately \$550 million. We used a portion of the proceeds from this transaction for general working capital, liquidation of our operating partnership units and to repay certain outstanding obligations. We intend to make opportunistic acquisitions with certain of the remaining proceeds from this transaction, and, if necessary or appropriate, from additional equity or debt financing sources.

---

## [Table of Contents](#)

## DEVELOPMENTS DURING 2010

### *We appointed a new President and Chief Executive Officer.*

On March 11, 2010, Gerald J. Ford submitted his resignation as President and Chief Executive Officer to the Board of Directors to the Company. Gerald J. Ford, however, will remain Chairman of the Board of the Company. As a result of this resignation, the Board of Directors appointed Jeremy B. Ford as the President and Chief Executive Officer of the Company, as well as director of the Company.

### *We had an extension to our loan agreement.*

On October 27, 2010, NLASCO renewed its line of credit with a financial institution. The line allows for borrowings by NLASCO up to \$5.0 million and is secured by substantially all of NLASCO's assets. The line of credit bears interest equal to a base rate, plus 3.75% (5.01% at December 31, 2010), which is due quarterly. This line of credit will expire in October 2011. As of December 31, 2010, there was no outstanding balance on the note.

## OVERVIEW OF RESULTS

For the year ended December 31, 2010, net loss attributable to common stockholders was \$13.5 million, or \$0.24 per share, as compared to a net loss attributable to common stockholders of \$12.4 million, or \$0.22 per share, for the year ended December 31, 2009, and a net loss attributable to common stockholders of \$32.9 million, or \$0.58 per share, for the year ended December 31, 2008.

Our results for 2010 include the \$5.9 million liquidation preference on the redemption of preferred stock, which occurred on September 6, 2010.

## Segments

NLASCO operates through its wholly-owned subsidiaries, NLIC and ASIC. Given the homogenous nature of our products, the regulatory environments in which we operate, the nature of our customers and our distribution channels, we now monitor, control and manage our business lines as an integrated entity offering fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. Accordingly, we only have insurance company segment information to disclose.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

We have prepared our consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, or GAAP, which requires us to make certain estimates and assumptions that affect the recorded amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates. We have provided a summary of our significant accounting policies in Note 1 to the accompanying consolidated financial statements as of, and for the year ended, December 31, 2010. We have summarized below those accounting policies that require our most difficult, subjective or complex judgments and that have the most significant impact on our financial condition and results of operations. Our management evaluates these estimates on an ongoing basis. These estimates are based on information currently available to management and on various other assumptions management believes are reasonable.

---

### [Table of Contents](#)

**Losses and Loss Adjustment Expenses.** The liability for losses and loss adjustment expenses represents estimates of the ultimate unpaid cost of all losses incurred, including losses for claims that have not yet been reported. Separately for each of NLIC and ASIC and each line of business, our actuaries estimate the liability for unpaid losses and loss adjustment expenses, or LAE, by first estimating ultimate losses and LAE amounts for each year, prior to recognizing the impact of reinsurance. There are several methods that our actuaries utilize to estimate ultimate loss and LAE amounts, including:

- Paid Loss Development Method;
- Reported Loss Development Method;
- Paid Bornhuetter-Ferguson Method; and
- Reported Bornhuetter-Ferguson Method.

**Paid and Reported Loss Development Methods.** Insured losses for a given year change in value over time as additional information on claims are received, as claim conditions change and as new claims are reported. This process is commonly referred to as “loss development.” To project ultimate losses and LAE, our actuaries examine the paid and reported (paid, plus case) losses and LAE and multiply these values by a loss development factor. The selected loss development factors are based upon a review of the loss development patterns indicated in the companies’ historical loss triangles and applicable insurance industry loss development factors.

**Paid and Reported Bornhuetter-Ferguson Methods.** The Bornhuetter-Ferguson, or BF, Method is a procedure that weights an expected ultimate loss and LAE amount, and the result of the loss development method. This method is useful when loss data is immature or sparse because it is not as sensitive as the loss development method to unusual variations in the paid or reported amounts. The BF method requires an initial estimate of expected ultimate losses and LAE. For each year, the expected ultimate losses and LAE is based on a review of the ultimate loss ratios indicated in the companies’ historical data and applicable insurance industry ultimate loss ratios. Each loss development factor, paid or reported, implies a certain percent of the ultimate losses and LAE is still unpaid or unreported. The amounts of unpaid or unreported losses and LAE by year are estimated as the percentage unpaid or unreported, times the expected ultimate loss and LAE amounts. To project ultimate losses and LAE, the actual paid or reported losses and LAE to date are added to the estimated unpaid or unreported amounts.

The results of each actuarial method performed by year are reviewed to select an ultimate loss and LAE amount for each year. In general, more weight is given to the loss development projections for more mature accident periods and more weight is given to the BF methods for less mature accident periods.

The combination of the methodologies described above is used for all lines of business, regardless of whether the line is a short-tailed or long-tailed line of business, though specific parameter selections within the methods vary to reflect the nature of the underlying line of business. ASIC and NLIC specialize in writing fire and extended coverage for low-value dwellings, mobile homes and homeowners, which generally are considered short-tailed coverages. In addition, ASIC and NLIC write a small amount of commercial risks, which are still predominantly property coverages, along with some low-limit liability coverages.

The methodology used by our actuaries is directly dependent upon the unique development characteristics of each line of business. For those lines of business with significant volume (homeowners, special property and commercial multiple peril), the selected loss development factors are derived from the historical development data for that line. For lines of business where the loss volume is small, insurance industry statistics regarding loss development for that line also are considered in selecting the loss development factors.

The estimated unpaid losses and LAE equal the estimated ultimate loss and LAE amounts, described above, less the cumulative paid amounts on known claims for each year. This estimate of unpaid losses and LAE is further segmented into case reserves on known claims and incurred-but-not-reported, or IBNR, reserves. IBNR reserves are calculated by reducing the estimate of unpaid losses and LAE by the case reserve amounts. In the normal course of operations, each case reserve is initially set at a standard amount determined from past payments for that type of

loss. Individual case reserves may be adjusted based on information indicating that the loss amount is actually over, or under, the standard amount. Most case reserves are not adjusted until the receipt of documentation concerning the amount to be paid on the loss. This usually occurs within seven days of the reporting of the claim, longer in the case of large scale catastrophic events.

---

[Table of Contents](#)

The reserve analysis performed by our actuaries provides preliminary central estimates of the unpaid losses and LAE. At each quarter-end, the results of the reserve analysis are summarized and discussed with our senior management. The senior management group considers many factors in determining the amount of reserves to record for financial statement purposes. These factors include the extent and timing of any recent catastrophic events, historical pattern and volatility of the actuarial indications, the sensitivity of the actuarial indications to changes in paid and reported loss patterns, the consistency of claims handling processes, the consistency of case reserving practices, changes in our pricing and underwriting, and overall pricing and underwriting trends in the insurance market.

Our recorded reserves reflect our best estimate as of a particular point in time based upon known facts, current law and our judgment. The carried reserve may differ from the actuarial central estimate as the result of our consideration of the factors noted above, as well as other factors impacting claims costs that may not be quantifiable through actuarial analysis. This process results in management's best estimate, which is then recorded as the reserve for unpaid losses and LAE.

The level of loss and LAE reserves we maintain represents our best estimate, as of a particular point in time, of the ultimate cost to settle and administer all claims based on our assessment of facts and circumstances known at that time. Reserves are not an exact calculation of liability, but instead are complex estimates that we derive, generally utilizing a variety of actuarial reserve estimation techniques, with numerous underlying assumptions and expectations about future events, both internal and external, many of which are highly uncertain.

The key assumptions fundamental to the reserving process are often different for various reserve categories and accident years. Some of these assumptions are explicit assumptions that are required of a particular method, but many assumptions are implicit and cannot be precisely quantified. An example of an explicit assumption is the pattern employed in the paid loss development method. However, the assumed pattern is itself based on several implicit assumptions, such as the impact of inflation on medical costs and the rate at which claim professionals close claims. Loss frequency is a measure of the number of claims per unit of insured exposure, and loss severity is a measure of the average size of claims. Each reserve segment has an implicit frequency and severity for each accident year as a result of the various assumptions made. As a result, the effect on reserve estimates of a particular change in assumptions usually cannot be specifically quantified, and changes in these assumptions cannot generally be tracked over time.

In light of the many uncertainties associated with establishing the estimates of ultimate losses and LAE, and making the assumptions necessary to establish recorded reserve levels, we review our reserve estimates on a regular basis and make adjustments in the period that the need for such adjustments is identified. The anticipated future emergence underlying our current estimates continues to reflect the historical patterns, and the selected development patterns have not changed significantly over the past few years.

Reserve estimates are subject to uncertainty from various sources, including, among others, changes in claim reporting patterns, claim settlement patterns, judicial decisions, legislation and economic conditions. In estimating the reserves for unpaid losses and LAE, it is necessary to project future loss and LAE payments. Actual future losses and LAE will not develop exactly as projected and may, in fact, vary significantly from the actuarially indicated projections. Further, these projections make no provision for extraordinary future emergence of new classes of losses or types of losses, which are not sufficiently represented in the companies' historical data or that are not yet quantifiable. Extraordinary future emergence can arise from an unforeseen broadening of coverage instigated by regulatory actions, judicial decisions or similar developments.

The underlying processes of establishing our best estimate of the liability for unpaid losses and LAE require the use of estimates, actuarial judgment and management considerations and, therefore, is an inherently uncertain process. The recorded reserves for the companies' liability for unpaid losses and LAE are estimates based on long term averages. Actual loss experience in any given year may differ from what is suggested by these averages. For some lines of business, the written premium volume is small and actual results are therefore subject to an exceptionally high degree of variability. While the recorded reserves are our best estimate as of a particular point in time, these reserves should be considered central estimates within a wide range of possible outcomes.

In arriving at our best estimate of the unpaid losses and LAE, and based on management discussion with our actuaries, we would consider reasonably likely changes in the key assumptions, such as the underlying loss development pattern or the expected loss ratio, to have an impact on our best estimate by +/- 10%. As of December 31, 2010, this equates to approximately +/- \$1.5 million, which represents approximately 0.2% of equity and 11.2% of calendar year 2010 losses.

---

[Table of Contents](#)

The following table presents our gross loss and LAE reserve amounts at December 31, 2010 and 2009 for each of NLIC and ASIC by line of business (dollars in thousands):

**For the year ended December 31, 2010**

<u>Company</u>	<u>Homeowners</u>	<u>Special Property</u>	<u>Commercial Multiple Peril</u>	<u>Other Liability</u>	<u>Fidelity &amp; Surety</u>	<u>All Lines</u>
----------------	-------------------	-------------------------	----------------------------------	------------------------	------------------------------	------------------

ASIC	\$	1,558	\$	325	\$	14	\$	1,021	\$	—	\$	2,918
NLIC		37,708		15,655		1,467		1,134		—		55,964
Consolidated	\$	39,266	\$	15,980	\$	1,481	\$	2,155	\$	—	\$	58,882

**For the year ended December 31, 2009**

<u>Company</u>	<u>Homeowners</u>	<u>Special Property</u>	<u>Commercial Multiple Peril</u>	<u>Other Liability</u>	<u>Fidelity &amp; Surety</u>	<u>All Lines</u>						
ASIC	\$	1,167	\$	390	\$	87	\$	923	\$	—	\$	2,567
NLIC		20,693		8,654		801		1,032		33		31,213
Consolidated	\$	21,860	\$	9,044	\$	888	\$	1,955	\$	33	\$	33,780

**Investment Securities.** At December 31, 2010, investment securities consist of U.S. Government, mortgage-backed, corporate debt and equity securities. We classify our fixed maturities in one of three categories: trading, available-for-sale or held-to-maturity. Our equity securities are classified as trading or available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity debt securities are those securities in which we have the ability, and intent, to hold the security until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of trading and available-for-sale securities are determined on a specific-identification basis.

We regularly review our investment securities to assess whether the security is impaired and if impairment is other-than-temporary. A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether impairment is other-than-temporary, we consider whether we are more likely than not to hold an investment until a market price recovery and consider whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to period end, and forecasted performance of the investee.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

**Deferred Acquisition Costs.** Costs of acquiring insurance vary with, and are related to, the production of new and renewal business, primarily consisting of commissions, premium taxes and underwriting expenses. These costs are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs reduce applicable unamortized acquisition costs in a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Future investment income is considered in determining the recoverability of deferred acquisition costs. The Company regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. A premium deficiency, and a corresponding charge to income, is recognized if the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceed related unearned premiums and anticipated investment income. At December 31, 2010, there was no premium deficiency.

[Table of Contents](#)

**Revenue Recognition.** Property and liability premiums are recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums. The Company routinely evaluates the premium receivable balance to determine if an allowance for uncollectible accounts is necessary.

Other income consists of premium installment charges, which are recognized when earned, and other miscellaneous income.

**Reinsurance.** In the normal course of business, NLASCO seeks to reduce losses that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Net premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE are reported as assets. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

The Company accounts for reinsurance contracts under the provisions of GAAP in accounting and reporting for reinsurance. Reinsurance assumed from other companies, including assumed premiums written and earned and losses and LAE, is accounted for in the same manner as direct insurance written.

**Income Taxes.** We have been in a taxable loss position since our inception and, as a result, we have substantial net operating loss carry-

forwards to offset taxable income and capital gains from the sale of discontinued operations. We have established a tax provision beginning on January 1, 2006.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recorded for the estimated future tax effects related to the temporary difference between the tax basis and book basis of assets and liabilities reported in the accompanying consolidated balance sheets. The provision for income tax expense or benefit differs from the amounts of income taxes currently payable because certain items of income and expense included in the consolidated financial statements are recognized in different time periods by taxing authorities.

ASC 740, specifically 740-10-25, *Recognition*, clarifies the accounting for uncertainty in income taxes recognized in financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740 requires that we determine whether the benefits of our tax positions are more likely than not of being sustained upon audit based on the technical merits of the tax position. For tax positions that are more likely than not of being sustained upon audit, we recognize the largest amount of the benefit that is more likely than not of being sustained in our consolidated financial statements. For tax positions that are not more likely than not of being sustained upon audit, we do not recognize any portion of the benefits in our consolidated financial statements.

Deferred tax assets, including net operating loss and tax credit carry forwards, are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that any portion of these tax attributes will not be realized. As a result of the allocation of the purchase price for the real estate assets we sold in 2007 by the purchaser, we reallocated \$34.1 million of gain recognized to those assets in the quarter ended September 30, 2008, the period in which the purchase price allocation was finalized. This reallocation resulted in a deferred tax benefit of \$4.6 million as of December 31, 2008. There is no valuation allowance as of December 31, 2010.

From time to time, management must assess the need to accrue or disclose a possible loss contingency for proposed adjustments from various Federal, state and foreign tax authorities that regularly audit the company in the normal course of business. In making these assessments, management often must analyze complex tax laws of multiple jurisdictions.

***Goodwill and Other Indefinite Lived Intangible Assets.*** Goodwill for HTH represents the excess of the cost over the fair value of the assets of NLASCO. Goodwill is tested annually for impairment and is tested more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.

## [Table of Contents](#)

The goodwill impairment analysis is a two-step test. The first step (Step #1), used to identify potential impairment involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. The Company has estimated fair values of reporting units based on a market approach using historic, normalized actual and forecast results. Management determined that HTH has two reporting units, which are the Parent (the holding company) and NLASCO (the insurance company).

The second step (Step #2) involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. An impairment loss cannot exceed the carrying value of goodwill assigned to a reporting unit, and the loss establishes a new basis in the goodwill. Subsequent reversal of goodwill impairment losses is not permitted.

At December 31, 2010, we determined that the estimated fair value of our reporting units exceeded their carrying values and, therefore, we did not perform the second step as described above. Consequently, we determined that no impairment existed with respect to goodwill and intangible assets at December 31, 2010.

## [Table of Contents](#)

### RESULTS OF OPERATIONS

#### *Comparison of the Year Ended December 31, 2010 to the Year Ended December 31, 2009*

***Results of insurance operations.*** The following table shows the underwriting gain or loss, as well as other revenue and expense items included in the financial results of NLASCO for the year ended December 31, 2010 and 2009 (in thousands). NLASCO's underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. NLASCO's underwriting performance is one of the most important factors in evaluating the overall results of operations given the fluctuations that can occur in loss and LAE due to weather related events, as well as the uncertainties involved in the process of estimating reserves for losses and LAE. The underwriting results and fluctuations in other revenue and expense items of NLASCO are discussed in greater detail below.



NLASCO Summary of Insurance Operations	Year Ended December 31,		Dollar	Percentage
	2010	2009		
Underwriting gain (loss)				
Homeowners	\$ (2,564)	\$ (4,227)	\$ 1,663	39.3%
Fire	1,844	3,556	(1,712)	-48.1%
Mobile Home	845	1,155	(310)	-26.8%
Commercial	1,779	967	812	84.0%
Other	188	209	(21)	-10.0%
Total underwriting gain	\$ 2,092	\$ 1,660	\$ 432	26.0%
Other revenue (expense items)				
Net investment income	5,873	6,165	(292)	-4.7%
Net realized gains on investments	137	83	54	65.1%
Other income	6,744	6,917	(173)	-2.5%
Depreciation and amortization	(1,788)	(1,981)	193	9.7%
Interest expense	(1,961)	(2,601)	640	24.6%
Total other revenue items	9,005	8,583	422	4.9%
Operating income before federal income taxes	11,097	10,243	854	8.3%
Federal income tax expense on operating income	3,934	3,578	356	9.9%
Net income from continuing operations of NLASCO	\$ 7,163	\$ 6,665	\$ 498	7.5%

*Revenue.* Revenue for the year ended December 31, 2010 was \$131.7 million, compared to \$128.8 million for the year ended 2009. This increase is due to net premiums earned of \$117.2 for the year ended 2010, compared to \$115.2 million for the year ended 2009, \$7.7 million of net investment income for the year ended 2010 compared to \$6.5 million for the year ended 2009, \$6.7 million of other income for the year ended 2010 compared to \$6.9 million in 2009 and \$0.1 million in net realized investment gains for the year ended 2010 as compared to \$0.3 million for the year ended 2009.

Net premiums earned are up \$2.0 million for the year ended 2010 as compared to the year ended 2009 due to higher net written premiums offset by greater change in net unearned premiums. Net investment income increased \$1.2 million for the year ended 2010 as compared to the year ended 2009 due to higher yields on the cash held at the parent (HTH).

*Underwriting Results.* The following table shows the components of NLASCO's underwriting gain for the year ended December 31, 2010 and 2009. NLASCO's underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

	Year Ended December 31,		Dollar	Percentage
	2010	2009		
Direct premiums written	\$ 139,290	\$ 131,309	\$ 7,981	6.1%
Net premiums written	\$ 121,691	\$ 114,743	\$ 6,948	6.1%
Net premiums earned	\$ 117,192	\$ 115,153	\$ 2,039	1.8%
Loss and LAE	70,943	70,295	648	0.9%
Policy acquisition and other underwriting expenses	44,157	43,198	959	2.2%
Underwriting gain (loss)	\$ 2,092	\$ 1,660	\$ 432	26.0%
Agency expenses	\$ (1,966)	\$ (2,051)	\$ 85	4.1%
Loss and LAE ratio	60.5%	61.0%	-0.5%	
Policy acquisition and other underwriting less agency expense ratio	36.0%	35.7%	0.3%	
Combined ratio	96.5%	96.8%	-0.3%	

## [Table of Contents](#)

The loss and LAE ratio is loss and LAE expenses divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense divided by net premiums earned for the same period. Combined ratio gives you the sum of both previous ratios.

Our combined ratio for the twelve months ended December 31, 2010 is 96.5%, as compared to 96.8% for the same period in 2009. The decrease in loss and LAE ratio in 2010 is due to lower average loss per claim, offset in part by the emergence of prior year claims in 2010. The higher loss and LAE ratio in 2009 is primarily due to the incurred losses related to non-catastrophic claims, specifically the wind and hail losses, which tended to be more significant than current experience.

The Company seeks to operate at a combined ratio of 85.0%, excluding Property Claim Services (PCS) catastrophic events. If PCS identifies a catastrophic event and the Company's losses exceed \$250,000 for that event, then management will internally identify the PCS event. Catastrophic events, including those that do not exceed our reinsurance retention, affect the Company's loss ratios. For the twelve months ended December 31, 2010, catastrophic events that did not exceed our reinsurance retention accounted for \$12.3 million of the total loss and loss adjustment expense, as compared to \$9.8 million for the same period in 2009. Excluding catastrophic events, our combined ratios for the twelve

months ended December 31, 2010 and 2009 would have been 86.0% and 88.2%, respectively.

For the twelve months ended December 30, 2010 and 2009, the Company had incurred losses related to two 2008 catastrophes, Hurricane Ike and Hurricane Dolly. Gross losses incurred from these storms were \$26.0 million for the year ended December 31, 2010, compared to \$24.3 million for the same period in 2009. The losses in the year ended December 31, 2010 relate primarily to lawsuits filed in response to the pending expiration of the statute of limitations. These losses have no effect on net loss and LAE incurred because the catastrophic events exceeded our retention and are fully recoverable. The primary financial effect is additional reinstatement premium payable to the affected reinsurers. For the year ended December 31, 2010 and 2009, the Company incurred reinstatement premiums of \$2.5 million and \$1.0 million, respectively.

*Premiums.* The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures that are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy, accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

Direct premiums written by major product line for the year ended December 31, 2010 and 2009 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2010	2009		
<b>Direct Premiums Written:</b>				
Homeowners	\$ 63,413	\$ 57,356	\$ 6,057	10.6%
Fire	45,637	46,815	(1,178)	-2.5%
Mobile Home	22,344	20,439	1,905	9.3%
Commercial	7,537	6,318	1,219	19.3%
Other	359	381	(22)	-5.8%
	<u>\$ 139,290</u>	<u>\$ 131,309</u>	<u>\$ 7,981</u>	<u>6.1%</u>

Total direct premiums written increased for the year ended December 31, 2010 for all insurance products except for fire and other due to the development of additional insurance products and a new channel of distribution in Oklahoma for our products. New homeowners insurance products generated \$8.3 million in direct written premiums for the twelve months ended December 31, 2010. For the same period in 2010, direct written premiums in Oklahoma increased \$1.7 million. In 2010, the Company began non-renewing policies in the first tier of the Texas sea coast and no longer writes full wind coverage along the Texas sea coast due to high losses and reinsurance costs. This has caused a decrease in homeowners and fire direct premiums written of \$4.4 million for the twelve months ended December 31, 2010. Mobile home products increased \$1.9 million due to increased production in Oklahoma, Georgia, Tennessee and Texas. Commercial products increased \$1.2 million due to new insurance product for owners of rental property. Most of the growth associated with this new commercial product occurred in the Texas market.

[Table of Contents](#)

Net premiums written by major product line for the year ended December 31, 2010 and 2009 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2010	2009		
<b>Net Premiums Written</b>				
Homeowners	\$ 55,401	\$ 50,119	\$ 5,282	10.5%
Fire	39,871	40,909	(1,038)	-2.5%
Mobile Home	19,521	17,861	1,660	9.3%
Commercial	6,585	5,521	1,064	19.3%
Other	313	333	(20)	-6.0%
	<u>\$ 121,691</u>	<u>\$ 114,743</u>	<u>\$ 6,948</u>	<u>6.1%</u>

Total net premiums written increased for the year ended December 31, 2010 for all lines of business, except fire and other, due to higher direct written premiums of \$8.0 million, offset in part by an increase in ceded premiums of \$1.2 million. Ceded premiums increased as a result of higher reinstatement premiums of \$1.5 million in 2010 as compared to 2009.

Net premiums earned by major product line for the year ended December 31, 2010 and 2009 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2010	2009		
<b>Net Premiums Earned:</b>				
Homeowners	\$ 53,353	\$ 50,299	\$ 3,054	6.1%
Fire	38,397	41,055	(2,658)	-6.5%
Mobile Home	18,799	17,924	875	4.9%
Commercial	6,341	5,540	801	14.5%
Other	302	335	(33)	-9.9%
	<u>\$ 117,192</u>	<u>\$ 115,153</u>	<u>\$ 2,039</u>	<u>1.8%</u>

Net premiums earned for the year ended December 31, 2010 increased as compared to 2009 due to an increase in net premiums written of \$6.9 million, offset by an increase in unearned premiums of \$4.9 million.

*Loss and Loss Adjustment Expenses.* Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the year ended December 31, 2010 and 2009 was 60.5% and 61.0%, respectively. The decrease in loss and LAE ratio in 2010 is due to lower average loss per claim for the 2010 accident year, offset in part by the emergence of prior year claims in 2010.

[Table of Contents](#)

The Company's net loss and LAE and the gross loss and LAE ratios for the year ended December 31, 2010 and 2009 are shown in the tables below:

	Year Ended December 31, 2010		Year Ended December 31, 2009	
<b>Loss and LAE (in thousands):</b>				
Homeowners	\$	35,814	\$	35,657
Fire		22,085		22,098
Mobile Home		10,871		10,045
Commercial		2,173		2,495
	\$	<u>70,943</u>	\$	<u>70,295</u>
<b>Incurred Claim Count:</b>				
Homeowners		8,010		10,417
Fire		6,273		7,775
Mobile Home		4,870		4,083
Commercial		998		387
		<u>20,151</u>		<u>22,662</u>
<b>Average Loss and LAE per Claim:</b>				
Homeowners	\$	4,471	\$	3,423
Fire		3,521		2,842
Mobile Home		2,232		2,460
Commercial		2,177		6,447
<b>Loss and LAE Ratio:</b>				
Homeowners		67.1%		70.9%
Fire		57.5%		53.8%
Mobile Home		57.8%		56.0%
Commercial		34.3%		45.0%

*Policy Acquisition and Other Underwriting Expenses.* Policy acquisition and other underwriting expenses for the year ended December 31, 2010 and 2009 were as follows (in thousands):

	Twelve Months Ended December 31,		Dollar	Percentage
	2010	2009		
Amortization of deferred policy acquisition costs	\$ 31,256	\$ 30,354	\$ 902	2.9%
Other underwriting expenses	12,901	12,844	57	0.4%
Total policy acquisition and other underwriting expenses	44,157	43,198	959	2.2%
Agency expenses	(1,966)	(2,051)	85	-4.3%
Total policy acquisition and other underwriting expenses less agency expenses	\$ 42,191	\$ 41,147	\$ 1,044	2.5%
Net premiums earned	\$ 117,192	\$ 115,153	\$ 2,039	1.7%
Expense ratio	36.0%	35.7%	0.3%	

Total policy acquisition and other underwriting expenses, less agency expenses, are up \$1.0 million for the twelve months ended December 31, 2010, as compared to the same period in 2009, due to higher amortization of deferred policy acquisition costs (DAC). DAC increased during the year ended December 31, 2010 due to increases in direct written premiums, as compared to the year ended 2009.

*General and Administrative Expense.* General and administrative expense for 2010 was \$7.4 million, as compared to \$7.1 million for 2009, an increase of \$0.3 million, or 3.9%. This increase is primarily due to an increase in professional fees of \$0.9 million, offset by decreases in salaries and benefits and management fees. The increase in professional fees is due to an increase in acquisition costs related to due diligence costs in 2010.

*Depreciation and Amortization Expense.* Depreciation and amortization expense was \$1.8 million for the year ended December 31, 2010, as compared to \$2.0 million in 2009.

*Interest Expense.* Interest expense was \$9.0 million for 2010, as compared to \$9.7 million for 2009, a decrease of \$0.7 million, or 7.2%. The decrease in interest expense is due to a decrease in the payable to the prior owner for redundant reserves as a result of a payment in February 2010.

[Table of Contents](#)

*Income Taxes.* The Company had a \$1.0 million income tax benefit for the year ended December 31, 2010, compared to \$1.3 million for 2009. The benefit decreased in 2010 due pre-tax losses of \$1.6 million for the year ended December 31, 2010 as compared to \$3.5 million loss for the same period in 2009 and the recoupment of \$0.6 million of state income taxes due to resolution of open state tax audits. We allocate income taxes in accordance with ASC 740, specifically 740-10-20.

*Preferred Stock Dividend.* On March 11, 2010 and June 10, 2010, the HTH board of directors declared quarterly cash dividends of \$0.5156 per share on each of the 5,000,000 outstanding shares of our Series A Preferred Stock, payable April 30, 2010 and July 30, 2010, amounting to \$2.6 million on each disbursement date. On August 6, 2010, the Company called for redemption all of the outstanding shares of its Series A Preferred Stock. The Series A Preferred Stock was redeemed on September 6, 2010, at a cash redemption price of \$25.2063 per share, representing the liquidation preference of \$25.00 per share, plus accrued and unpaid dividends to, and including, the date of redemption. For the twelve months ended December 31, 2010, the dividend was \$1.2375 per share as compared to \$2.0625 per share in the twelve months ended December 31, 2009.

*Net Loss Attributable to Common Stockholders.* As a result of the foregoing, our net loss attributable to common stockholders was \$13.5 million for 2010, as compared to \$12.4 million for 2009, an increase of \$1.1 million. The majority of this difference is due higher loss and LAE of \$0.6 million, higher policy acquisition and other underwriting expenses of \$1.0 million and loss on redemption of preferred stock of \$5.9 million, offset by higher revenues of \$2.9 million and lower preferred stock dividend of \$3.3 million.

**Comparison of the Year Ended December 31, 2009 to the Year Ended December 31, 2008**

*Results of insurance operations.* The following table shows the underwriting gain or loss, as well as other revenue and expense items included in the financial results of NLASCO for the year ended December 31, 2009 and 2008 (in thousands). NLASCO's underwriting gain or loss consists of net premiums earned less loss and LAE and policy acquisition and other underwriting expenses. NLASCO's underwriting performance is one of the most important factors in evaluating the overall results of operations given the fluctuations that can occur in loss and LAE due to weather related events, as well as the uncertainties involved in the process of estimating reserves for losses and LAE. The underwriting results and fluctuations in other revenue and expense items of NLASCO are discussed in greater detail below.

NLASCO Summary of Insurance Operations	Year Ended December 31,		Dollar	Percentage
	2009	2008		
<b>Underwriting gain (loss)</b>				
Homeowners	\$ (4,227)	\$ (7,596)	\$ 3,369	44.4%
Fire	3,556	(2,324)	5,880	253.0%
Mobile Home	1,155	844	311	36.8%
Commercial	967	220	747	339.5%
Other	209	216	(7)	-3.2%
Total underwriting gain(loss)	\$ 1,660	\$ (8,640)	\$ 10,300	119.2%
<b>Other revenue (expense items)</b>				
Net investment income	6,165	8,255	(2,090)	-25.3%
Net realized gains (losses) on investments	83	(4,035)	4,118	102.1%
Other income	6,917	6,147	770	12.5%
Depreciation and amortization	(1,981)	(2,159)	178	8.2%
Interest expense	(2,601)	(3,644)	1,043	28.6%
Total other revenue (expense) items	8,583	4,564	4,019	88.1%
Operating income (loss) before federal income taxes	10,243	(4,076)	14,319	351.3%
Federal income tax expense (benefit) on operating income	3,578	(1,434)	5,012	349.5%
Net income (loss) from continuing operations of NLASCO	\$ 6,665	\$ (2,642)	\$ 9,307	352.3%

*Revenue.* Revenue for the year ended December 31, 2009 was \$128.8 million, compared to \$102.5 million in 2008. This increase is due to the realized gains on investments of \$0.3 million for year ended 2009, compared to realized investment losses of \$46.0 million for the year ended 2008 and \$6.5 million of net investment income for the year ended 2009 compared to \$27.1 million in 2008 due to having the cash at HTH (parent only) earning no interest. The Investment Committee elected to deposit the cash at HTH (parent only) in non-interest bearing accounts, taking advantage of the Temporary Liquidity Guarantee Program to preserve principal. The \$128.8 million in revenue in 2009 is comprised of net premiums earned of \$115.2 million, net investment income of \$6.5 million, other income of \$6.9 million and net realized gains on investments of \$0.3 million. The \$102.5 million in revenue in 2008 is comprised of net premiums earned of \$115.2 million, net investment income of \$27.1 million, other income of \$6.1 million and net realized losses on investments of \$46.0 million.

*Underwriting Results.* The following table shows the components of NLASCO's underwriting gain for the year ended December 31, 2009 and 2008. NLASCO's underwriting gain or loss consists of net premiums earned, less loss and LAE and policy acquisition and other underwriting expenses. The underwriting results are discussed below (in thousands).

	Year Ended December 31,		Dollar	Percentage
	2009	2008		
Direct premiums written	\$ 131,309	\$ 132,642	\$ (1,333)	-1.0%
Net premiums written	\$ 114,743	\$ 113,285	\$ 1,458	1.3%
Net premiums earned	\$ 115,153	\$ 115,247	\$ (94)	-0.1%
Loss and LAE	70,295	80,435	(10,140)	-12.6%
Policy acquisition and other underwriting expenses	43,198	43,452	(254)	-0.6%
Underwriting gain (loss)	\$ 1,660	\$ (8,640)	\$ 10,300	119.2%
Agency expenses	\$ (2,051)	\$ (2,375)	\$ 324	13.6%
Loss and LAE ratio	61.0%	69.8%	-8.8%	
Policy acquisition and other underwriting less agency expense ratio	35.7%	35.6%	0.1%	
Combined ratio	96.8%	105.4%	-8.6%	

The loss and LAE ratio is loss and LAE expenses divided by net premiums earned for the same period. The policy acquisition and other underwriting expense ratio is policy acquisition and other underwriting expense divided by net premiums earned for the same period. Combined ratio gives you the sum of both previous ratios.

Our combined ratio for the twelve months ended December 31, 2009 is 96.8%, as compared to 105.4% for the same period in 2008. The decrease in loss and LAE ratio in 2009 is due to less severe weather and lower overall loss experience due to no catastrophic events occurring in 2009. The loss and LAE ratio in 2008 is due to the incurred losses related to Hurricanes Dolly, Gustav and Ike of \$83.1 million (including loss adjustment expenses and gross incurred but not reported reserves) in catastrophic related losses for the year ended December 31, 2008. For the year ended December 31, 2008, NLASCO's net catastrophic loss experience was \$13.0 million after reinsurance.

The industry aggregate for combined ratio for 2008, was 104.7%, which is slightly below the combined ratio for NLIC and ASIC of 105.4%, for the same period.

The Company seeks to operate at a combined ratio of 85.0%, excluding Property Claim Services (PCS) catastrophic events. If PCS identifies a catastrophic event and the Company's losses exceed \$250,000 for that event, then management will internally identify the PCS event. Catastrophic events, including those that do not exceed our reinsurance retention, affect the Company's loss ratios. For the twelve months ended December 31, 2009, catastrophic events that did not exceed our reinsurance retention accounted for \$9.8 million of the total loss and loss adjustment expense, as compared to \$12.0 million for the same period in 2008. Excluding catastrophic events, our combined ratios for the twelve months ended December 31, 2009 and 2008 would have been 88.2% and 95.0%, respectively.

For the twelve months ended December 31, 2009 and 2008, the Company had incurred losses related to two 2008 catastrophes, Hurricane Ike and Hurricane Dolly. Gross losses incurred from these storms were \$24.3 million for the year ended December 31, 2009, compared to \$70.0 million for the same period in 2008. These losses have no effect on net loss and LAE incurred because the catastrophic events exceeded our retention and are fully recoverable. The primary financial effect is additional reinstatement premium payable to the affected reinsurers. For the year ended December 31, 2009 and 2008, the Company incurred reinstatement premiums of \$2.5 million and \$8.2 million, respectively.

*Premiums.* The property and casualty insurance industry is affected by soft and hard market business cycles. During a soft market, price competition tends to increase as insurers are willing to reduce premium rates in order to maintain growth in premium volume. The soft market makes it more difficult to attract new business, as well as retain exposures that are adequately priced. Although we recognize the need to remain competitive in the marketplace, the Company remains committed to its disciplined underwriting philosophy, accepting only risks that are appropriately priced, while declining risks which are under priced for the level of coverage provided.

## [Table of Contents](#)

Direct premiums written by major product line for the year ended December 31, 2009 and 2008 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2009	2008		
<b>Direct Premiums Written:</b>				
Homeowners	\$ 57,356	\$ 58,942	\$ (1,586)	-2.7%
Fire	46,815	48,014	(1,199)	-2.5%
Mobile Home	20,439	19,483	956	4.9%
Commercial	6,318	5,804	514	8.9%
Other	381	399	(18)	-4.5%
	\$ 131,309	\$ 132,642	\$ (1,333)	-1.0%



Total direct premiums written decreased for the year ended December 31, 2009, for all insurance products, except for mobile home and commercial, as a result of stronger competition and more challenging economic times.

Net premiums written by major product line for the year ended December 31, 2009 and 2008 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2009	2008		
<b>Net Premiums Written</b>				
Homeowners	\$ 50,119	\$ 50,340	\$ (221)	-0.4%
Fire	40,909	41,007	(98)	-0.2%
Mobile Home	17,861	16,640	1,221	7.3%
Commercial	5,521	4,957	564	11.4%
Other	333	341	(8)	-2.3%
	\$ 114,743	\$ 113,285	\$ 1,458	1.3%

Total net premiums written increased for the year ended December 31, 2009, in the mobile home and commercial lines of business. Reinstatement premiums related to Hurricanes Dolly, Gustav and Ike of \$8.2 million decreased net premiums written in 2008, partially offset by higher reinsurance costs and lower direct premiums in 2009.

Net premiums earned by major product line for the year ended December 31, 2009 and 2008 are presented in the table below (in thousands):

	Year Ended December 31,		Dollar	Percentage
	2009	2008		
<b>Net Premiums Earned:</b>				
Homeowners	\$ 50,299	\$ 51,212	\$ (913)	-1.8%
Fire	41,055	41,717	(662)	-1.6%
Mobile Home	17,924	16,928	996	5.9%
Commercial	5,540	5,043	497	9.9%
Other	335	347	(12)	-3.5%
	\$ 115,153	\$ 115,247	\$ (94)	-0.1%

Net premiums earned for the year ended December 31, 2009 decreased as compared to 2008 due to gross earned premiums decreasing \$3.3 million, which was partially offset by lower ceded premiums of \$3.2 million in 2009. Direct premiums written decreased 1% in 2009, which also contributed to the decrease in net premiums earned.

[Table of Contents](#)

*Loss and Loss Adjustment Expenses.* Loss and LAE are recognized based on formula and case basis estimates for losses reported with respect to direct business, estimates of unreported losses based on past experience and deduction of amounts for reinsurance placed with reinsurers. The loss and LAE ratio is calculated by taking the ratio of incurred losses and LAE to net premiums earned. The loss and LAE ratio for the year ended December 31, 2009 and 2008 of 61.0% and 69.8%, respectively, has been adjusted to remove the effect of losses attributable to the prior owner. The increase in the loss and LAE ratio is due to several catastrophic hurricanes that occurred in July and September 2008. The actual loss related to Hurricane Dolly, Gustav, and Ike, excluding reinstatement premium, was \$13.0 million after reinsurance.

The Company's net loss and LAE and the gross loss and LAE ratios for the year ended December 31, 2009 and 2008 are shown in the tables below (in thousands, except claim count figures):

	Year Ended December 31, 2009	Year Ended December 31, 2008
<b>Loss and LAE (in thousands):</b>		
Homeowners	\$ 35,657	\$ 39,499
Fire	22,098	28,312
Mobile Home	10,045	9,702
Commercial	2,495	2,922
	\$ 70,295	\$ 80,435
<b>Incurred Claim Count:</b>		
Homeowners	10,417	13,024
Fire	7,775	11,062
Mobile Home	4,083	3,882
Commercial	387	618
	22,662	28,586
<b>Average Loss and LAE per Claim:</b>		
Homeowners	\$ 3,423	\$ 3,033
Fire	2,842	2,559
Mobile Home	2,460	2,499

Commercial	6,447	4,728
<b>Loss and LAE Ratio:</b>		
Homeowners	70.9%	77.1%
Fire	53.8%	67.9%
Mobile Home	56.0%	57.3%
Commercial	45.0%	57.9%

*Policy Acquisition and Other Underwriting Expenses.* Policy acquisition and other underwriting expenses for the year ended December 31, 2009 and 2008 were as follows (in thousands):

	<b>Twelve Months Ended December 31,</b>		<b>Dollar</b>	<b>Percentage</b>
	<b>2009</b>	<b>2008</b>		
Amortization of deferred policy acquisition costs	\$ 30,354	\$ 29,469	\$ 885	3.0%
Other underwriting expenses	12,844	13,983	(1,139)	-8.1%
Total policy acquisition and other underwriting expenses	43,198	43,452	(254)	-0.6%
Agency expenses	(2,051)	(2,375)	324	13.6%
Total policy acquisition and other underwriting expenses less agency expenses	\$ 41,147	\$ 41,077	\$ 70	0.2%
Net premiums earned	\$ 115,153	\$ 115,247	\$ (94)	-0.1%
Expense ratio	35.7%	35.6%	0.1%	

Total policy acquisition and other underwriting expenses, less agency expenses, are up only \$0.1 million from 2008 due to higher amortization of deferred policy acquisition costs, offset by lower other underwriting expenses and lower agency expenses. Agency expenses are related to our general agent, Nalico GA, and are removed from total policy acquisition and other underwriting expenses because they have no effect on the expense ratios of the insurance companies.

## [Table of Contents](#)

*General and Administrative Expense.* General and administrative expense for 2009 was \$7.2 million, as compared to \$8.1 million for 2008, a decrease of \$0.9 million, or 12%. This decrease is primarily due to a decrease in professional fees, which consisted of acquisition costs of \$1.2 million in 2008 versus \$0.2 million in 2009. The acquisition costs related to expenses incurred in connection with a possible transaction, that, at the end of the second quarter of 2008, we determined no longer to pursue.

*Depreciation and Amortization Expense.* Depreciation and amortization expense was \$2.0 million for the year ended December 31, 2009, as compared to \$2.1 million in 2008.

*Interest Expense.* Interest expense was \$9.7 million for 2009, as compared to \$10.5 million for 2008, a decrease of \$0.8 million, or 8%. The decrease in interest expense is due to lower labor rates on variable rate debt in 2009.

*Income Taxes.* The Company had a \$1.3 million income tax benefit for the year ended December 31, 2009, compared to \$19.6 million for 2008. The benefit decreased in 2009 due to realized investment losses of \$41.9 million in 2008 at HTH (parent only) and net income before taxes of \$10.2 million in 2009, versus a net loss before taxes of \$4.1 million in 2008 at NLASCO. We allocate income taxes in accordance with ASC 740, specifically 740-10-20.

*Preferred Stock Dividend.* In each of the years ended December 31, 2009 and 2008, we recorded four quarterly preferred stock dividends declared at the annual rate of 8.25%, or \$2.0625 per share on the 5.0 million shares of Series A Preferred Stock outstanding.

*Net Loss Attributable to Common Stockholders.* As a result of the foregoing, our net loss attributable to common stockholders was \$12.4 million for 2009, as compared to \$32.9 million for 2008, a decrease of \$20.5 million. The majority of this difference is due to losses on investments in 2008 of \$46.0 million, partially offset by higher net investment income in 2008 of \$27.1 million.

## **LIQUIDITY AND CAPITAL RESOURCES**

HTH is a holding company whose assets primarily consist of the stock of its subsidiaries and invested assets with a combined value of \$940 million at December 31, 2010. HTH's primary investment objectives, as a holding company, are to preserve capital and have available cash resources to utilize in making opportunistic acquisitions, and, if necessary or appropriate, from additional equity or debt financing sources.

As of December 31, 2010, we had approximately \$649 million in cash and cash equivalents, consisting of approximately \$601 million owned by the parent company and \$48 million owned by NLASCO and its subsidiaries. At December 31, 2010, we had total investments of approximately \$149 million, consisting of investments in available-for-sale equities with a fair value of \$8.8 million and \$140.2 million in carrying value of fixed maturities securities owned by NLASCO and its subsidiaries.

In September 2010, the Company redeemed all of its outstanding shares of Series A preferred stock at a cash redemption price of \$25.2063 per share, representing the liquidation preference of \$25.00 per share, plus accrued and unpaid dividends to, and including, the date of redemption.

As of December 31, 2010, we had \$138.4 million of debt, consisting of \$90.9 million of senior exchangeable notes and \$47.5 million of debt

owed by NLASCO and its subsidiaries.

Our short-term liquidity needs as of December 31, 2010 include (a) funds to pay our insurance claims of NLASCO and subsidiaries and (b) funds to service our total debt of \$138.4 million.

Our insurance operating subsidiary, NLASCO, has primary investment objectives to preserve capital and manage for a total rate of return in excess of a specified benchmark portfolio. NLASCO's strategy is to purchase securities in sectors that represent the most attractive relative value. Bonds, cash and short-term investments constituted \$188.2 million, or 95.5%, of NLASCO's \$197.0 million in investments at December 31, 2010. NLASCO had \$8.8 million, or 4.5% of its investments, in equity investments as of December 31, 2010. We currently do not have any significant concentration in both direct and indirect guarantor exposure. NLASCO has no investments in subprime mortgages. NLASCO has custodial agreements with A.G. Edwards and Wells Fargo Bank and an investment management agreement with DTF Holdings, LLC.

57

---

## [Table of Contents](#)

NLASCO's liquidity requirements are met primarily by positive cash flow from operations and investment activity. Primary sources of cash from insurance operations are premiums and other considerations, net investment income and investment sales and maturities. Primary uses of cash include payments of claims, operating expenses and income taxes, funds to service \$47.5 million of debt and purchases of investments. NLASCO's insurance subsidiaries have regulatory restrictions on the amount of dividends they can declare.

The investment committee meets regularly to review the portfolio performance and investment markets in general. Our management generally meets monthly to review the performance of investments and monitor market conditions for investments that would warrant any revision to investment guidelines.

We believe that existing cash and investment balances, when combined with anticipated cash flows from operations and dividends from our insurance companies, will be adequate to meet our expected liquidity needs for the reasonably foreseeable future. We will continue to pursue and investigate possible strategic opportunities. In that regard, we may need to secure external financing. We cannot assure you that we will be successful in obtaining any such financing or in the implementation of our business plan. See "Item 1A. Risk Factors" starting on page 22.

### **Restrictions on Dividends and Distributions**

Aside from available cash and investment income on our invested assets, as a holding company we rely on dividends and other permitted distributions from our subsidiaries. The payment of dividends from our insurance subsidiaries, NLIC and ASIC, is subject to significant regulatory restrictions and limitations under debt agreements limiting their ability to declare and pay dividends.

Under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner, dividends cannot be declared or distributed that exceed the greater of ten percent of the company's surplus, as shown by its last statement on file with the Commissioner, or one hundred percent of net income for such period. The subsidiaries paid \$14.0 million in dividends to NLASCO in March 2008, no dividends in 2009 and \$6.0 million in March 2010. At December 31, 2010, the maximum dividend that may be paid to NLASCO in 2011 without regulatory approval is approximately \$11.9 million.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At December 31, 2010, NLASCO's insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the National Association of Insurance Commissioners, or NAIC, has adopted risk-based capital, or RBC, requirements for insurance companies that establish minimum capital requirements relating to insurance risk, credit risk, interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At December 31, 2010, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

We believe that restrictions on liquidity resulting from restrictions on the payments of dividends by our subsidiary companies will not have a material impact on our ability to carry out our normal business activities, including debt payments on our senior exchangeable notes.

### **CASH FLOWS**

#### ***Comparison of the Year Ended December 31, 2010 to the Year Ended December 31, 2009***

Cash provided by operations was \$9.9 million in 2010, as compared to \$18.9 million in 2009. Cash provided by operations decreased \$9.0 million primarily due to increase in deferred acquisition costs of \$1.7 million, decrease in cash received from income taxes of \$20.2 million, decrease in payable to related party of \$4.4 million, offset by decrease in net loss of \$1.6 million, increase in deferred income taxes of \$0.5 million, increase in unearned premiums of \$5.0 million and changes in operating assets and liabilities of \$10.2 million.

The increase in deferred acquisition costs is attributable to increases in unearned premiums, which was a result of higher written premiums in the year ended December 2010 as compared to 2009. The decrease in income taxes payable is due to receiving \$1.9 million in refunds on income taxes in 2010 as compared to receiving \$23.4 million in refunds in 2009. Changes in operating assets and liabilities increased \$10.2 million due to increases in loss and LAE reserves of \$6.3 million, increases in

58

---

[Table of Contents](#)

reinstatement premiums payable of \$5.4 million, decreases in investments of \$0.5 million and decreases in premium and agents' balances of \$1.0 million.

Cash used in investing activities was \$16.7 million in 2010, as compared to cash provided by investing activities of \$32.1 million in 2009. The decrease in cash provided by investing activities of \$48.8 million was primarily due to proceeds from maturities and purchases of available-for-sale securities decreasing \$26.1 million and a decrease in restricted cash of \$18.5 million.

Cash used in financing activities was \$133.8 million in 2010, as compared with \$10.3 million in 2009. The increase in cash used in financing activities primarily was due to the redemption of preferred stock in 2010 of \$125 million.

#### *Comparison of the Year Ended December 31, 2009 to the Year Ended December 31, 2008*

Cash provided by operations was \$18.9 million in 2009, as compared to \$7.2 million used by operations in 2008. Cash provided by operations increased primarily due to a decrease in income taxes receivable of \$22.4 million, offset by operating losses of \$2.1 million.

Cash provided by investing activities was \$32.1 million in 2009, as compared to cash used in investing activities of \$12.1 million in 2008. The increase in cash provided by investing activities primarily was due to proceeds from sales of available-for-sale securities of \$23.6 million and the release of restricted cash of \$18.5 million, which was offset by purchases and maturities of available-for-sale securities of \$8.4 million.

Cash used by financing activities was \$10.3 million in 2009, as compared with \$14.3 million in 2008. The decrease in cash used in financing activities primarily was due to the repayment of debt in 2008 of \$4.0 million.

#### INFLATION

Inflation in the U.S. has been relatively low in recent years and did not have a material impact on our results of operations for the years ended December 31, 2010, 2009 and 2008. Although the impact of inflation has been relatively insignificant in recent years, it remains a factor in the U.S. economy and may increase the cost of labor and utilities.

#### COMMITMENTS

At December 31, 2010, we had \$138.4 million of outstanding indebtedness. It consists of the following: \$90.9 million, or 66%, of our total indebtedness is fixed rate and \$47.5 million, or 34%, is variable rate. At December 31, 2010, we had the following indebtedness outstanding with the following repayment obligations (in thousands):

	Principal Commitments			Interest Commitments			Total Debt Commitments		
	Fixed	Variable	Total	Fixed	Variable(1)	Total	Fixed	Variable	Total
2011	\$ —	\$ —	\$ —	\$ 6,814	\$ 2,214	\$ 9,028	\$ 6,814	\$ 2,214	\$ 9,028
2012	—	—	—	6,814	2,608	9,422	6,814	2,608	9,422
2013	—	—	—	6,814	3,050	9,864	6,814	3,050	9,864
2014	—	—	—	6,814	3,491	10,305	6,814	3,491	10,305
2015	—	—	—	6,814	3,815	10,629	6,814	3,815	10,629
Thereafter	90,850	47,500	138,350	74,954	72,485	147,439	165,804	119,985	285,789
Commitments	\$ 90,850	\$ 47,500	\$ 138,350	\$ 109,024	\$ 87,663	\$ 196,687	\$ 199,874	\$ 135,163	\$ 335,037

(1) For variable rate debt, interest commitments were calculated as expected interest payments based on the weighted average of current interest rates.

At December 31, 2010 the following table shows our outstanding commitments for leases (in thousands).

Lease Obligations	Payments Due by Period		
	Less than 1 year	1-3 years	Total
Total lease obligations	\$ 519	\$ 1,558	\$ 2,077

[Table of Contents](#)

NLASCO's loss reserves do not have contractual maturity dates. Based on historical payment patterns, however, the following table estimates when management expects the loss reserves to be paid. The timing of payments is subject to significant uncertainty. NLASCO maintains a portfolio of investments with varying maturities to provide adequate cash flows for the payment of claims.

	Reserves in thousands
2011	\$ 32,562
2012	13,484

2013	8,067
2014	3,945
2015	471
Thereafter	353
	<u>\$ 58,882</u>

The following table sets forth certain information with respect to our indebtedness outstanding as of December 31, 2010 and 2009 excluding indebtedness related to assets held for sale (in thousands):

	<u>Year Ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
Senior exchangeable notes due 2025, 7.50% per annum	\$ 90,850	\$ 90,850
Insurance company line of credit due October 2011, base rate less 0.5% per annum	—	—
NLIC note payable due May 2033, three-month LIBOR plus 4.10% (4.40% at December 31, 2010)	10,000	10,000
NLIC note payable due September 2033, three-month LIBOR plus 4.05% (4.35% at December 31, 2010)	10,000	10,000
ASIC note payable due April 2034, three-month LIBOR plus 4.05% (4.35% at December 31, 2010)	7,500	7,500
Insurance company note payable due March 2035, three-month LIBOR plus 3.40% (3.70% at December 31, 2010)	20,000	20,000
	<u>\$ 138,350</u>	<u>\$ 138,350</u>

## RECENT ACCOUNTING PRONOUNCEMENTS

In July 2010, the FASB issued ASU-2010-20 to amend Topic 310 to improve the disclosures that an entity provides about the credit quality of its financing receivables and the related allowance for credit losses. As a result of these amendments, an entity is required to disaggregate by portfolio segment or class certain existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses. The updated guidance is effective for periods ending after December 15, 2010. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In October 2010, the FASB issued ASU-2010-26 to address the diversity in practice for the accounting for costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost must be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. The updated guidance is effective for periods ending after December 15, 2011. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In December 2010, the FASB issued ASU-2010-29 to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. The amendments in the update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments in this update are effective

## [Table of Contents](#)

prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our future income, cash flows and fair values relevant to financial instruments are dependent upon prevalent market interest rates. Market risk refers to the risk of loss from adverse changes in market prices and interest rates. We currently do not use derivative financial instruments to manage, or hedge, interest rate risks related to our borrowings. We do not use derivatives for trading or speculative purposes and only enter into contracts with major financial institutions based on their credit rating and other factors.

As of December 31, 2010 our total debt outstanding was \$138.4 million, comprised of approximately \$90.9 million of indebtedness subject to fixed interest rates. Approximately \$47.5 million, or 34%, of our total consolidated debt is variable rate debt.

If LIBOR and the prime rate were to increase by one eighth of one percent (0.125%), the increase in interest expense on the variable rate debt would decrease future earnings and cash flows by approximately \$59,000 annually.

Interest risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of any change in overall economic activity that could occur in that environment. Further, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.



The fair value of debt outstanding as of December 31, 2010 was approximately \$137.2 million.

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Our financial statements required by this item are submitted as a separate section of this Annual Report on Form 10-K. See “Financial Statements,” commencing on page F-1 hereof.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

## **ITEM 9A. CONTROLS AND PROCEDURES**

### **CONCLUSION REGARDING THE EFFECTIVENESS OF DISCLOSURE CONTROLS AND PROCEDURES**

Our management, with the participation of our Chief Executive Officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this Form 10-K. Based on such evaluation, our Chief Executive Officer and principal financial officer have concluded that, as of the end of such period, our disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

## [Table of Contents](#)

## **MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our board of directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorization of our management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2010. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Based on our assessment, management concluded that, as of December 31, 2010, our internal control over financial reporting is effective.

The effectiveness of our internal control over financial reporting as of December 31, 2010, has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm as stated in their report, which appears on Page F-2 of this Annual Report on Form 10-K.

## **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

There have not been any changes in our internal controls over financial reporting during the year ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

## **ITEM 9B. OTHER INFORMATION**

None

## **PART III**

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

## ITEM 11. EXECUTIVE COMPENSATION

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, or in Item 5 of this Annual Report on Form 10-K for the year ended December 31, 2010, and is incorporated herein by reference.

62

---

### [Table of Contents](#)

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

## ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

The information called for by this Item is contained in our definitive Proxy Statement for our 2011 Annual Meeting of Stockholders, and is incorporated herein by reference.

63

---

### [Table of Contents](#)

## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed herewith as part of this Form 10-K.

	<u>Page</u>
1. Financial Statements.	
Hilltop Holdings, Inc.	
<a href="#">Report of Independent Registered Public Accounting Firm</a>	F-2
<a href="#">Consolidated Balance Sheets as of December 31, 2010 and 2009</a>	F-3
<a href="#">Consolidated Statements of Operations for the Years Ended December 31, 2010, 2009, and 2008</a>	F-4
<a href="#">Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2010, 2009 and 2008</a>	F-5
<a href="#">Consolidated Statements of Cash Flows for the Years Ended December 31, 2010, 2009, and 2008</a>	F-6
<a href="#">Notes to Consolidated Financial Statements</a>	F-7
2. Financial Statement Schedules.	
Schedule I Summary of Investments — Other Than Investments in Related Parties	
Schedule IV Reinsurance	
3. Exhibits. See the Exhibit Index following the signature page hereto.	

64

---

### [Table of Contents](#)

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HILLTOP HOLDINGS INC.

By: /s/ JEREMY B. FORD  
 Jeremy B. Ford  
 Chief Executive Officer  
 (Principal Executive Officer and duly authorized officer)

MARCH 11, 2011

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the date indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ JEREMY B. FORD</u> Jeremy B. Ford	President, Chief Executive Officer and Director (Principal Executive Officer)	March 11, 2011
<u>/s/ DARREN PARMENTER</u> Darren Parmenter	Senior Vice President (Principal Financial and Accounting Officer)	March 11, 2011
<u>/s/ RHODES BOBBITT</u> Rhodes Bobbitt	Director and Audit Committee Member	March 11, 2011
<u>/s/ W. JORIS BRINKERHOFF</u> W. Joris Brinkerhoff	Director	March 11, 2011
<u>/s/ CHARLES R. CUMMINGS</u> Charles R. Cummings	Director and Chairman of Audit Committee	March 11, 2011
<u>/s/ J. MARKHAM GREEN</u> J. Markham Green	Director and Audit Committee Member	March 11, 2011
<u>/s/ JESS T. HAY</u> Jess T. Hay	Director	March 11, 2011
<u>/s/ WILLIAM T. HILL, JR.</u> William T. Hill, Jr.	Director	March 11, 2011
<u>/s/ W. ROBERT NICHOLS, III</u> W. Robert Nichols, III	Director	March 11, 2011
<u>/s/ C. CLIFTON ROBINSON</u> C. Clifton Robinson	Director	March 11, 2011
<u>/s/ KENNETH D. RUSSELL</u> Kenneth D. Russell	Director	March 11, 2011
<u>/s/ CARL B. WEBB</u> Carl B. Webb	Director	March 11, 2011

[Table of Contents](#)

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
3.1*	Articles of Amendment and Restatement of Affordable Residential Communities Inc., dated February 16, 2004, as amended or supplemented by: Articles Supplementary, dated February 16, 2004; Corporate Charter Certificate of Notice, dated June 6, 2005; Articles of Amendment, dated January 23, 2007; Articles of Amendment, dated July 31, 2007; Corporate Charter Certificate of Notice, dated September 23, 2008; and Articles Supplementary, dated December 15, 2010.
3.2	Second Amended and Restated Bylaws of Hilltop Holdings Inc. (filed as Exhibit 3.2 to the Registrant's Current Report on Form 8-K filed on March 16, 2009, and incorporated herein by reference).
4.1	Form of Certificate of Common Stock of Hilltop Holdings Inc. (filed as Exhibit 4.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2007, and incorporated herein by reference).
4.2	First Amended and Restated Pairing Agreement, dated February 12, 2004, by and between Affordable Residential Communities Inc. and Affordable Residential Communities LP (filed as Exhibit 4.5 to the Registrant's Annual Report on

Form 10-K for the year ended December 31, 2007 and incorporated herein by reference).

- 4.3 Corporate Charter Certificate of Notice, dated June 6, 2005 (filed as Exhibit 3.2 to the Registrant's Registration Statement on Form S-3 (File No. 333-12585) and incorporated herein by reference).
- 4.4.1 Indenture, dated August 9, 2005, by and between Affordable Residential Communities LP and U.S. Bank National Association, as Trustee, regarding the 7½% Senior Exchangeable Notes Due 2025 of Affordable Residential Communities LP (filed as Exhibit 4.7.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 4.4.2 Form of Waiver to the Indenture, dated August 9, 2005, by and between Affordable Residential Communities LP and U.S. Bank National Association, as Trustee, with respect to the 7½% Senior Exchangeable Notes Due 2025 (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on July 17, 2007, and incorporated herein by reference).
- 10.1.1 First Amended and Restated Agreement of Limited Partnership of Affordable Residential Communities LP, dated February 11, 2004 (filed as Exhibit 10.1.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2007 and incorporated herein by reference).
- 10.1.2 Amendment to the First Amended and Restated Agreement of Limited Partnership of Affordable Residential Communities LP, dated July 3, 2007 (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on July 6, 2007, and incorporated herein by reference).
- 10.2.1† Affordable Residential Communities Inc. 2003 Equity Incentive Plan (filed as Exhibit 10.5 to the Registrant's Registration Statement on Form S-11 (File No. 333-109816) and incorporated herein by reference).
- 10.2.2† Form of Restricted Stock Grant Agreement for use under the Affordable Residential Communities Inc. 2003 Equity Incentive Plan (filed as Exhibit 10.2.2 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.2.3\*† Form of Affordable Residential Communities Inc. 2003 Equity Incentive Plan Non-Qualified Stock Option Agreement.

---

[Table of Contents](#)

- 10.3† Affordable Residential Communities Inc. Management Incentive Plan (filed as Exhibit 10.6 to the Registrant's Registration Statement on Form S-11 (File No. 333-109816) and incorporated herein by reference).
- 10.4 Registration Rights Agreement, dated August 9, 2005, among Affordable Residential Communities LP, Affordable Residential Communities Inc. and Merrill Lynch, Pierce, Fenner & Smith Incorporated (filed as Exhibit 10.5 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.5 Common Stock Delivery Agreement, dated August 9, 2005, by and between Affordable Residential Communities LP and Affordable Residential Communities Inc. (filed as Exhibit 10.6 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.6 Stock Purchase Agreement, dated October 6, 2006, by and among Affordable Residential Communities Inc., ARC Insurance Holdings Inc., C. Clifton Robinson, C.C. Robinson Property, Ltd. and the Robinson Charitable Remainder Unitrust (filed as Exhibit 2.1 to the Registrant's Current Report on Form 8-K filed on October 10, 2006, and incorporated herein by reference).
- 10.7 Registration Rights Agreement, dated January 31, 2007, by and between Affordable Residential Communities Inc. and C. Clifton Robinson. (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
- 10.8 Stock Purchase Agreement, dated October 6, 2006, by and between Affordable Residential Communities Inc. and Flexpoint Fund, L.P. (filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
- 10.9 Registration Rights Agreement, dated January 31, 2007, by and between Affordable Residential Communities Inc. and Flexpoint Fund, L.P. (filed as Exhibit 10.2 to the Registrant's Current Report on Form 8-K filed on February 5, 2007, and incorporated herein by reference).
- 10.10† Employment Agreement, dated January 31, 2007, by and between NLASCO, Inc. and C. Clifton Robinson (filed as Exhibit 10.17 to the Registrant's Annual Report on Form 10-K/A (Amendment No. 1) for the year ended December 31, 2007, and incorporated herein by reference).
- 10.11† Employment Agreement, dated August 15, 2007, by and between Hilltop Holdings Inc. and Darren Parmenter (filed as Exhibit 10.18 to the Registrant's Annual Report on Form 10-K/A (Amendment No. 1) for the year ended December 31, 2007, and incorporated herein by reference).

- 10.12.1† Management Services Agreement, dated April 28, 2008, but effective as of January 1, 2008, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.17 to the Registrant's Current Report on Form 8-K filed on April 30, 2008 and incorporated herein by reference).
- 10.12.2† First Amendment to Management Services Agreement, dated as of March 15, 2010, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.14.2 to the Registrant's Current Report on Form 8-K filed on March 17, 2010, and incorporated herein by reference).

---

[Table of Contents](#)

- 10.12.3† Second Amendment to Management Services Agreement, dated as of April 30, 2010, by and between Hilltop Holdings Inc. and Diamond A Administration Company LLC (filed as Exhibit 10.14.3 to the Registrant's Current Report on Form 8-K filed on May 5, 2010, and incorporated herein by reference).
- 10.13† Employment Agreement, dated January 31, 2007, by and between NLASCO, Inc. and Greg Vanek (filed as Exhibit 10.15 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.14† Retirement and Release Agreement, dated December 1, 2009, by and between Hilltop Holdings Inc. and Larry D. Willard (filed as Exhibit 10.16 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2009 and incorporated herein by reference).
- 10.15† Compensation arrangement with Jeremy B. Ford (filed as Exhibit 10.17 to the Registrant's Current Report on Form 8-K/A (Amendment No. 1) filed on May 5, 2010, and incorporated herein by reference).
- 14.1 Hilltop Holdings, Inc. Code of Business Conduct and Ethics (filed as Exhibit 14.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008, and incorporated herein by reference).
- 21.1\* List of subsidiaries of the Registrant.
- 23.1\* Consent of PricewaterhouseCoopers LLP.
- 31.1\* Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
- 31.2\* Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.
- 32.1\* Certification of Chief Executive Officer of Affordable Residential Communities Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer of Affordable Residential Communities Inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

---

\* Filed herewith.

† Exhibit is a management contract or compensatory plan.

---

[Table of Contents](#)

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES**

	<u>Page</u>
<a href="#">Report of Independent Registered Public Accounting Firm</a>	F-2
<a href="#">Consolidated Balance Sheets as of December 31, 2010 and 2009</a>	F-3
<a href="#">Consolidated Statements of Operations for the Years Ended December 31, 2010, 2009 and 2008</a>	F-4
<a href="#">Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2010, 2009 and 2008</a>	F-5
<a href="#">Consolidated Statements of Cash Flows for the Years Ended December 31, 2010, 2009 and 2008</a>	F-6
<a href="#">Notes to Consolidated Financial Statements</a>	F-7

---

[Table of Contents](#)

**Report of Independent Registered Public Accounting Firm**

To The Board of Directors and Stockholders of Hilltop Holdings Inc.:



In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Hilltop Holdings Inc. and its subsidiaries (the “Company”) at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the index appearing under Item 15(a)(2) present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management’s Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on the Company’s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Dallas, Texas  
March 11, 2011

F-2

[Table of Contents](#)

<b>HILLTOP HOLDINGS INC.</b>		
<b>CONSOLIDATED BALANCE SHEETS</b>		
<b>AS OF DECEMBER 31, 2010 and 2009</b>		
<b>(in thousands except share and per share data)</b>		
	<b>December 31, 2010</b>	<b>December 31, 2009</b>
<b>Assets</b>		
Investments		
Fixed maturities		
Available for sale securities, at fair value (amortized cost of \$115,344 and \$107,738 respectively)	\$ 123,162	\$ 113,157
Held-to-maturity securities, at amortized cost (fair value of \$18,059 and \$17,244, respectively)	17,035	16,539
Equity securities		
Available for sale securities, at fair value (cost of \$8,478 and \$234, respectively)	8,768	272
Total investments	148,965	129,968
Cash and cash equivalents	649,439	790,013
Accrued interest and dividends	1,519	1,494
Premiums receivable	22,490	20,955
Deferred acquisition costs	17,237	15,745
Reinsurance receivable, net of uncollectible amounts	45,655	21,769
Prepaid reinsurance premiums	4,898	4,728
Income tax receivable	—	2,187
Deferred income taxes	9,115	11,531

Goodwill	23,988	23,988
Intangible assets, definite life	7,599	9,241
Intangible assets, indefinite life	3,000	3,000
Property and equipment, net	2,021	1,845
Loan origination costs, net	2,871	3,068
Other assets	844	1,220
Total Assets	<u>\$ 939,641</u>	<u>\$ 1,040,752</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Reserve for losses and loss adjustment expenses	\$ 58,882	\$ 33,780
Unearned premiums	72,814	68,145
Reinsurance payable	5,666	1,100
Accounts payable and accrued expenses	8,600	8,381
Income taxes payable	78	—
Notes payable	138,350	138,350
Dividends payable	—	1,719
Other liabilities	2,196	5,500
Total liabilities	<u>286,586</u>	<u>256,975</u>
Commitments and Contingencies (see Note 16)		
<b>Stockholders' Equity</b>		
Series A preferred stock, \$0.01 par value, 0 shares designated, issued and outstanding at December 31, 2010 and 5,750,000 shares designated, 5,000,000 shares issued and outstanding at December 31, 2009	—	119,108
Common stock, \$0.01 par value, 100,000,000 shares authorized, 56,495,410 and 56,485,405 shares issued and outstanding at December 31, 2010 and 2009, respectively	565	565
Additional paid-in capital	918,046	917,896
Accumulated other comprehensive gain	5,270	3,547
Accumulated deficit	(270,826)	(257,339)
Total stockholders' equity	<u>653,055</u>	<u>783,777</u>
Total liabilities and stockholders' equity	<u>\$ 939,641</u>	<u>\$ 1,040,752</u>

The accompanying notes are an integral part of these consolidated financial statements.

F-3

[Table of Contents](#)

**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE YEARS ENDED DECEMBER 31, 2010, 2009 and 2008**  
(in thousands except per share data)

	2010	2009	2008
<b>Revenue:</b>			
Net premiums earned	\$ 117,192	\$ 115,153	\$ 115,247
Net investment income	7,664	6,458	27,143
Other income	6,744	6,917	6,147
Net realized (losses) gains on investments			
Other-than-temporary impairments on fixed maturity securities	(70)	(841)	(4,267)
Other realized investment gains (losses), net	207	1,148	(41,725)
Total realized investment gains (losses), net	137	307	(45,992)
Total revenue	<u>131,737</u>	<u>128,835</u>	<u>102,545</u>
<b>Expenses:</b>			
Loss and loss adjustment expenses	70,943	70,295	80,435
Policy acquisition and other underwriting expenses	44,157	43,198	43,452
General and administrative expenses	7,433	7,154	8,115
Depreciation and amortization	1,788	1,981	2,159
Interest expense	8,971	9,668	10,528
Total expenses	<u>133,292</u>	<u>132,296</u>	<u>144,689</u>
Loss before income tax benefit	(1,555)	(3,461)	(42,144)
Income tax benefit	1,007	1,349	19,559
Net loss	(548)	(2,112)	(22,585)
Preferred stock dividend	(7,047)	(10,313)	(10,313)

Loss on redemption of preferred stock	(5,892)	—	—
Net loss attributable to common stockholders	<u>\$ (13,487)</u>	<u>\$ (12,425)</u>	<u>\$ (32,898)</u>
Loss per share attributable to common stockholders			
Basic loss per share	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>
Diluted loss per share	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>
Weighted average share information			
Basic shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>
Diluted shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>

The accompanying notes are an integral part of these consolidated financial statements.

F-4

[Table of Contents](#)

**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**FOR THE YEARS ENDED DECEMBER 31, 2010, 2009 and 2008**  
(in thousands)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive (Loss) Income	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance, December 31, 2007	<u>5,000</u>	<u>\$ 119,108</u>	<u>56,461</u>	<u>\$ 564</u>	<u>\$ 917,582</u>	<u>\$ (1,053)</u>	<u>\$ (212,016)</u>	<u>\$ 824,185</u>
Net loss							(22,585)	(22,585)
Other comprehensive income, net of tax of \$37						68		68
Total comprehensive loss							(10,313)	(10,313)
Preferred stock dividends declared								167
Common stock issued to board members			16		167			(215)
Shares redeemed			(21)		(215)			148
Stock compensation expense					148			
Balance, December 31, 2008	<u>5,000</u>	<u>\$ 119,108</u>	<u>56,456</u>	<u>\$ 564</u>	<u>\$ 917,682</u>	<u>\$ (985)</u>	<u>\$ (244,914)</u>	<u>\$ 791,455</u>
Net loss							(2,112)	(2,112)
Other comprehensive income, net of tax of \$2,440						4,532		4,532
Total comprehensive income								2,420
Preferred stock dividends declared							(10,313)	(10,313)
Common stock issued to board members			12	1	136			137
Options exercised			17					—
Stock compensation expense					78			78
Balance, December 31, 2009	<u>5,000</u>	<u>\$ 119,108</u>	<u>56,485</u>	<u>\$ 565</u>	<u>\$ 917,896</u>	<u>\$ 3,547</u>	<u>\$ (257,339)</u>	<u>\$ 783,777</u>
Net loss							(548)	(548)
Other comprehensive income, net of tax of \$928						1,723		1,723
Total comprehensive income								1,175
Preferred stock dividends declared							(7,047)	(7,047)
Redemption of Series A preferred stock	(5,000)	(119,108)					(5,892)	(125,000)
Common stock issued to board members			10		111			111
Common stock retired					(2)			(2)
Stock compensation expense					41			41
Balance, December 31, 2010	<u>—</u>	<u>\$ —</u>	<u>56,495</u>	<u>\$ 565</u>	<u>\$ 918,046</u>	<u>\$ 5,270</u>	<u>\$ (270,826)</u>	<u>\$ 653,055</u>

The accompanying notes are an integral part of these consolidated financial statements

F-5

[Table of Contents](#)

**HILLTOP HOLDINGS INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED**  
**DECEMBER 31, 2010, 2009 and 2008**  
(in thousands)

Cash flow from operating activities:	For the Twelve Months Ended December 31		
	2010	2009	2008

Net loss	\$	(548)	\$	(2,112)	\$	(22,585)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:						
Depreciation and amortization		1,788		1,981		2,159
Decrease in deferred income taxes		1,488		995		7,216
Increase (decrease) in unearned premiums		4,669		(306)		41
(Increase) decrease in deferred acquisition costs		(1,492)		190		(1,414)
Realized (gains) losses on investments		(137)		(307)		45,992
Amortization of loan origination costs		197		197		197
Stock grant compensation expense		150		214		100
Decrease (increase) in income tax receivable		2,187		22,411		(24,598)
Increase (decrease) in income tax payable		78		—		(12,238)
(Decrease) increase in payable to related party		(3,651)		761		(613)
Changes in operating assets and liabilities		5,122		(5,124)		(1,447)
Net cash provided by (used in) operating activities	\$	9,851	\$	18,900	\$	(7,190)

#### Cash flow from investing activities:

Purchases of available-for-sale securities		(43,123)		(1,094,906)		(42,864)
Purchases of held-to-maturity securities		(1,606)		(331)		(9,761)
Proceeds from sales of available-for-sale securities		16,726		23,647		39,829
Proceeds from maturities of available-for-sale securities		8,316		1,086,227		12,777
Proceeds from maturities of held-to-maturity securities		3,350		646		6,863
Purchases of fixed assets		(322)		(1,715)		(98)
Decrease (increase) in restricted cash		—		18,500		(18,500)
Purchase of NALICO GA		—		—		(375)
Net cash (used in) provided by investing activities	\$	(16,659)	\$	32,068	\$	(12,129)

#### Cash flow from financing activities:

Repayment of debt		—		(18)		(4,000)
Payment of preferred dividends		(8,766)		(10,313)		(10,313)
Redemption of preferred stock		(125,000)		—		—
Net cash used in financing activities		(133,766)		(10,331)		(14,313)
Net (decrease) increase in cash and cash equivalents		(140,574)		40,637		(33,632)
Cash and cash equivalents, beginning of period		790,013		749,376		783,008
Cash and cash equivalents, end of period	\$	649,439	\$	790,013	\$	749,376

#### Non-cash financing and investing transactions:

Dividends declared but unpaid	\$	—	\$	1,719	\$	1,719
-------------------------------	----	---	----	-------	----	-------

#### Supplemental cash flow information:

Cash paid for interest	\$	8,799	\$	9,209	\$	10,350
Cash paid for income taxes	\$	(1,907)	\$	(23,890)	\$	10,634

The accompanying notes are an integral part of these consolidated financial statements

#### [Table of Contents](#)

### HILLTOP HOLDINGS INC. NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010, 2009 and 2008

#### 1. Business, Basis of Presentation and Summary of Significant Accounting Policies

##### Business

Hilltop Holdings Inc., (“Hilltop”, “HTH”, or the “Company”), was organized in July 1998 as a Maryland corporation. HTH is a holding company that is endeavoring to make opportunistic transactions. In connection with this strategy, we are identifying and evaluating potential targets on an ongoing basis.

NLASCO, Inc. is a Delaware corporation that specializes in providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. NLASCO operates through its wholly-owned subsidiaries, National Lloyds Insurance Company (“NLIC”) and American Summit Insurance Company (“ASIC”). Texas comprises approximately 73% of our business, with Arizona 8%, Tennessee 6%, Oklahoma 5%, Louisiana and Georgia 2%, respectively, and the remaining states in which we do business makes up the other 4%.

Our common stock is listed on the New York Stock Exchange under the symbol “HTH”. We have no public trading history prior to February 12, 2004.

## **Basis of Presentation**

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America (“GAAP”), and in conformity with the rules and regulations of the Securities and Exchange Commission. The consolidated financial statements include the accounts of all wholly-owned subsidiaries of the Company. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

We are required by GAAP to make estimates and assumptions that affect our reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of our financial statements and our reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates. These estimates and assumptions are particularly important in determining reserves for losses and loss adjustment expenses, deferred policy acquisition costs, reinsurance receivables and potential impairment of assets.

## **Summary of Significant Accounting Policies**

### *Investment Securities*

Investment securities at December 31, 2010 consisted of U.S. Government, mortgage-backed, corporate debt and equity securities. We classify our fixed maturities in one of three categories: trading, available-for-sale or held-to-maturity. Our equity securities are classified as trading or available-for-sale. Trading securities are bought and held principally for the purpose of selling them in the near term. Held-to-maturity debt securities are those securities in which we have the ability and intent to hold the security until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

F-7

---

### [Table of Contents](#)

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity debt securities are recorded at amortized cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in earnings. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income until realized. Realized gains and losses from the sale of trading and available-for-sale securities are determined on a specific-identification basis.

We regularly review our investment securities to assess whether the security is impaired and if impairment is other-than-temporary. A decline in the market value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether impairment is other-than-temporary, we consider whether we are more likely than not to hold an investment until a market price recovery and consider whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to period end, and forecasted performance of the investee.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

### *Cash and Cash Equivalents*

Cash and cash equivalents include all cash and liquid investments with maturities less than 90 days from the date of purchase.

### *Restricted Cash*

On January 5, 2009, the third party loan for which we provided a guaranty and designated as restricted cash of \$18.5 million was repaid in full, thus relieving us of any further obligation. At December 31, 2010, we had no cash and cash equivalents designated as restricted.

### *Premiums Receivable*

Premiums receivable include premiums written and not yet collected. The company routinely evaluates the receivable balance to determine if an allowance for uncollectible amounts is necessary. At December 31, 2010 and 2009, the Company determined no valuation allowance was necessary.

### *Deferred Acquisition Costs*

Costs of acquiring insurance vary with and are primarily related to the production of new and renewal business, primarily consisting of commissions, premium taxes and underwriting expenses, and are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Proceeds from reinsurance transactions that represent recovery of acquisition costs reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized. Future investment income is considered in determining the recoverability of deferred acquisition costs. The Company regularly reviews the categories of acquisition costs that are deferred and assesses the recoverability of this asset. A premium deficiency and a corresponding charge to income is recognized if



the sum of the expected loss and loss adjustment expenses, unamortized acquisition costs, and maintenance costs exceed related unearned premiums and anticipated investment income. At December 31, 2010 and 2009, there was no premium deficiency.

#### Reinsurance

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy.

Net premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned premiums ceded to them are reported as assets. Reinsurance assumed from other companies, including assumed premiums written and earned and losses and LAE, is accounted for in the same manner as direct insurance written.

F-8

### [Table of Contents](#)

#### Goodwill and Other Intangible Assets

Goodwill is the excess of cost over fair value of net assets acquired. Goodwill is tested annually for impairment and is tested more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. For goodwill, the impairment determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of a reporting unit and compares it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Management determined that HTH has two reporting units, which are the Parent (the holding company) and NLASCO (the insurance company).

Other indefinite lived intangible assets consist of \$3.0 million of estimated fair value of state licenses acquired in the NLASCO purchase. The annual impairment test is conducted in conjunction with the annual impairment test of goodwill.

#### Finite Lived Intangible Assets

We record finite lived intangible assets at the estimated fair value of the assets acquired and amortize the assets over their estimated useful lives. The following finite lived intangible assets were acquired when the Company purchased NLASCO (in thousands).

	<u>Estimated Fair Value</u>	<u>Estimated Useful Life</u>
Customer relationships	\$ 6,100	12 years
Agent relationships	3,600	13 years
Trade name	3,500	15 years
Software	1,500	5 years
Total	\$ 14,700	
Less accumulated amortization	(7,101)	
Balance at December 31, 2010	\$ 7,599	

Customer and agent relationships are amortized using the sum of the years digits method to approximate the non-renewal rate of customers and attrition of agents. The trade name and software are amortized using the straight-line method.

#### Property and Equipment

We carry property and equipment at cost, less accumulated depreciation. We expense maintenance and repairs as incurred. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the various classes of furniture and equipment assets are as follows:

<u>Asset Class</u>	<u>Estimated Useful Lives (Years)</u>
Furniture and other equipment	5
Computer software and hardware	3

#### Loan Origination Costs

We capitalize loan origination costs associated with financing of debt. These costs are amortized on a straight-line basis, which approximates the effective interest method, over the repayment term of the loans. We amortized \$0.2 million of loan origination costs for the years ended December 31, 2010, 2009, and 2008, which is included in interest expense. Accumulated amortization was \$1.0 million, \$0.9 million and

## [Table of Contents](#)

### *Other Assets*

Included in other assets are prepaid insurance and other miscellaneous prepaid expenses of \$0.5 million and \$0.6 million for the years ended December 31, 2010 and 2009, respectively.

### *Reserve for Losses and Loss Adjustment Expenses*

The liability for losses and loss adjustment expenses includes an amount determined from loss reports and individual cases and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The liability for losses and loss adjustment expenses has not been reduced for reinsurance recoverable.

### *Income Taxes*

We have been in a taxable loss position since our inception and as a result we have net operating loss carry-forwards to offset operating profits and capital gains from profits from asset sales.

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recorded for the estimated future tax effects of the temporary difference between the tax basis and book basis of assets and liabilities reported in the accompanying consolidated balance sheets. The provision for income tax expense or benefit differs from the amounts of income taxes currently payable because certain items of income and expense included in the consolidated financial statements are recognized in different time periods by taxing authorities.

ASC 740, specifically 740-10-25, *Recognition*, clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with GAAP. ASC 740 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We determine whether the benefits of our tax positions are more likely than not of being sustained upon audit based on the technical merits of the tax position. For tax positions that are more likely than not of being sustained upon audit, we recognize the largest amount of the benefit that is more likely than not of being sustained in our consolidated financial statements. For tax positions that are not more likely than not of being sustained upon audit, we do not recognize any portion of the benefits in our consolidated financial statements.

Deferred tax assets, including net operating loss and tax credit carry forwards, are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that any portion of these tax attributes will not be realized. There was no valuation allowance recorded as of December 31, 2010 or 2009.

### *Convertible Debt*

In August 2005, our Operating Partnership, or OP issued \$96.6 million aggregate principal amount of senior notes which are exchangeable at an initial rate of 69.8812 shares of common stock per \$1,000 principal amount of the notes and callable under certain circumstances. The notes are treated as a combined instrument and not bifurcated to separately account for any embedded derivative instruments principally because in accordance with ASC 815, *Derivatives and Hedging*, (i) the conversion feature is indexed to HTH's common stock and would be classified in stockholders' equity if it were a freestanding derivative and (ii) the put and call option features are clearly and closely related to the notes at fixed conversion amounts. As a result of our rights offering in January 2007, at which we offered shares of our common stock for sale at a below-market price of \$8 per share, the exchangeable rate of our convertible debt was adjusted to 73.95 shares of common stock per \$1,000 principal amount of the notes equal to an initial exchange rate of \$13.52 per share.

## [Table of Contents](#)

### *Stock Based Compensation*

Stock-based compensation expense for all share-based payment awards granted after December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of ASC 718. We recognize these compensation costs for only those awards expected to vest over the service period of the award.

We consider the number of vested shares issued under our 2003 equity incentive plan as common stock outstanding and include them in the denominator of our calculation of basic earnings per share. We also consider the total number of unvested restricted shares granted under our 2003 equity incentive plan in the denominator of our calculation of diluted earnings per share if they are dilutive. We return shares forfeited to the 2003 equity incentive plan as shares eligible for future grant and adjust any compensation expense previously recorded on such shares in the period the forfeiture occurs.

### *Warrants*

On August 9, 2000, while the Company was privately held, 1,250,000 warrants were issued to all existing shareholders at the time of entering into a significant cash equity contribution agreement with a new shareholder. The warrants give each holder the right to purchase one share of our common stock at an original exercise price of \$11.70 per share. The Company received no cash or other consideration from the existing shareholders for the warrants. Because the warrants were issued in conjunction with an equity contribution, they are considered a cost of equity issuance and there is no impact on the financial statements from the issuance of the warrants because all transactions are recorded within additional paid-in capital. Because the Company received no consideration for the warrants and because there was no active market for our common stock or warrants at the time of issuance in 2000, we determined that the fair value of the warrants was immaterial. The warrants expired unexercised at 5:00 PM, New York City time, on July 23, 2010. As a result, the exercise price per share and outstanding warrants were reduced to zero.

#### *Accumulated Other Comprehensive Income*

Amounts recorded in accumulated other comprehensive income as of December 31, 2010 and 2009 represent unrecognized gains or losses on our investment portfolio. Total accumulated other comprehensive gain as of December 31, 2010 and 2009 is \$5.3 million \$3.5 million gain net of income taxes, respectively.

#### *Revenue Recognition*

Property and liability premiums are recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future is deferred and reported as unearned premiums. Other income consists of premium installment charges, which are recognized when earned, and other miscellaneous income. The Company routinely evaluates the premium receivable balance to determine if an allowance for uncollectible accounts is necessary.

#### *Statutory Accounting Practices*

NLASCO is required to report its results of operations and financial position to insurance regulatory authorities based upon statutory accounting practices, or SAP. The significant differences between SAP and GAAP include: 1) under SAP NLASCO is required to expense all sales and other policy acquisition costs as they are incurred rather than capitalizing and amortizing them over the expected life of the policy as required by GAAP. The immediate charge off of sales and acquisition expenses and other conservative valuations under SAP generally causes a lag between the sale of a policy and the emergence of reported earnings. Because this lag can reduce the Company's gain from operations on a SAP basis, it can have the effect of reducing the amount of funds available for dividends from insurance companies; 2) under SAP certain assets are designated as "non admitted" and are charged directly to unassigned surplus, whereas under GAAP, such assets are included in the balance sheet net of an appropriate valuation reserve; 3) under SAP investments are carried at amortized book value and under GAAP, certain investments are carried at fair value; 4) surplus notes are classified as capital and surplus under SAP but classified as notes payable under GAAP; 5) ceded reinsurance receivables are netted against reserves under SAP, but are classified as assets under GAAP; 6) under SAP, while statutory deferred incomes taxes are provided on temporary differences between the statutory and tax basis of assets and liabilities, statutory deferred tax assets are limited based on admissibility tests and allowed

---

#### [Table of Contents](#)

deferred income taxes are recorded in unassigned statutory surplus rather than the income statement; and 7) under SAP, the statutory statement of cash flows follows a prescribed method included in the annual statement instructions issued by the National Association of Insurance Commissioners to present changes in amounts in balance sheet accounts which may not reflect actual cash flows from transactions or operations; whereas the cash flows presented in these financial statements are presented in accordance with GAAP.

#### *Recently Adopted Accounting Pronouncements*

In June 2009, FASB issued new guidance on the accounting for the transfers of financial assets. The new guidance, which was issued as ASC 860, *Transfers and Servicing*, requires additional disclosures for transfers of financial assets, including securitization transactions, and any continuing exposure to the risks related to transferred financial assets. There is no longer a concept of a qualifying special-purpose entity, and the requirements for derecognizing financial assets have changed. The Company has not transferred any financial assets; therefore, there is no impact of adopting ASC 860 as of January 1, 2010 on its financial statements.

In June 2009, FASB issued revised guidance on the accounting for variable interest entities. The revised guidance, which was issued as ASC 810, *Consolidation*, reflects the elimination of the concept of a qualifying special-purpose entity and replaces the quantitative-based risks and rewards calculation of the previous guidance for determining which company, if any, has a controlling financial interest in a variable interest entity. The revised guidance requires an analysis of whether a company has: (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb the losses that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity. An entity is required to be re-evaluated as a variable interest entity when the holders of the equity investment at risk, as a group, lose the power, from voting rights or similar rights, to direct the activities that most significantly impact the entity's economic performance. Additional disclosures are required about a company's involvement in variable interest entities and an ongoing assessment of whether a company is the primary beneficiary. The Company currently has no interest in a variable interest entity; therefore, there is no impact of adopting ASC 810 as of January 1, 2010 on its financial statements.

In January 2010, FASB issued new guidance on additional disclosures to fair market values. The new guidance, which was issued as ASU 2010-06, amends ASC 820, *Fair Value Measurements and Disclosures*. ASU 2010-06 requires more robust disclosures regarding the different classes of assets and liabilities measured at fair value, the valuation technique and inputs used, the activity in Level 3 fair value measurements and the transfers between Levels 1, 2 and 3. The effective date of this ASU is the first interim or annual reporting period beginning after December 15,

2009, except for the gross presentation of the Level 3 roll forward information, which is required for annual reporting periods beginning after December 15, 2010 and for interim reporting periods within those years. The Company made the disclosures required by this ASU within this Form 10-K; and, there is no impact of adopting the language as prescribed by this ASU as of January 1, 2010 on its financial statements.

In February 2010, FASB issued amendments to ASC 855-10, *Subsequent Events*. The guidance was issued as ASU 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements* and requires SEC filers to evaluate subsequent events through the date that the financial statements are issued. This amendment clarifies previously issued guidance and does not require an SEC filer to disclose the date through which subsequent events have been evaluated. ASU 2010-09 also further defines revised financial statements to include financial statements revised either as a result of correction of an error or retrospective application of U.S. GAAP. The Company made the disclosures required by this ASU within this Form 10-K; and, there is no impact of adopting the language as prescribed by this ASU on its financial statements.

In July 2010, the FASB issued ASU-2010-20 to amend Topic 310 to improve the disclosures that an entity provides about the credit quality of its financing receivables and the related allowance for credit losses. As a result of these amendments, an entity is required to disaggregate by portfolio segment or class certain existing disclosures and provide certain new disclosures about its financing receivables and related allowance for credit losses. The updated guidance is effective for periods ending after December 15, 2010. The adoption of this guidance did not have a material impact on the Company's financial statements.

F-12

## [Table of Contents](#)

### *Recently Issued Accounting Pronouncements*

In October 2010, the FASB issued ASU-2010-26 to address the diversity in practice for the accounting for costs associated with acquiring or renewing insurance contracts. This guidance modifies the definition of acquisition costs to specify that a cost must be directly related to the successful acquisition of a new or renewal insurance contract in order to be deferred. If application of this guidance would result in the capitalization of acquisition costs that had not previously been capitalized by a reporting entity, the entity may elect not to capitalize those costs. The updated guidance is effective for periods ending after December 15, 2011. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

In December 2010, the FASB issued ASU-2010-29 to address diversity in practice about the interpretation of the pro forma revenue and earnings disclosure requirements for business combinations. The amendments in the update specify that if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. The amendments also expand the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The amendments in this update are effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

## **2. Revision of previously filed financial statements**

Management has determined that, since issuance of the Series A Preferred Stock in February 2004, it has incorrectly included preferred stock dividends declared as a component of total comprehensive income (loss) as presented on the Consolidated Statement of Stockholders' Equity. In accordance with SAB 108, management has further determined, however, that the inclusion of the preferred stock dividends as a component of total comprehensive income (loss) did not materially misstate the historical financial statements and, accordingly, restatement of previously issued financial statements is not necessary. This change has no impact on current or historical net income, earnings per share, cash flows or total stockholders' equity. Since management has determined that this presentation was in error, the current period presentation does not reflect preferred stock dividends as a component of total comprehensive income (loss) and management corrected the presentation in the financial statements for the years ended December 31, 2009 and 2008 in connection with filing of the Annual Report on Form 10-K for the year ended December 31, 2010. The total comprehensive loss as originally presented in the consolidated statement of stockholders' equity for the years ended December 31, 2009 and 2008 was \$7.9 million and \$32.8 million, respectively. The revised amounts presented in the accompanying consolidated statement of stockholders' equity are \$2.4 million of total comprehensive income and \$22.5 million of total comprehensive loss, respectively, for the same periods.

F-13

## [Table of Contents](#)

### **3. Investments**

The amortized cost (original cost for equity securities), gross unrealized holding gains and losses, and fair value of available-for-sale and held-to-maturity securities by major security type and class of security at December 31, 2010 and 2009 were as follows (in thousands).

<b>December 31, 2010</b>			
<b>Cost and Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>

Available-for-sale securities:				
Fixed maturities:				
Government securities	\$ 14,883	\$ 1,118	\$ —	\$ 16,001
Residential mortgage-backed securities	12,563	1,078	—	13,641
Commercial mortgage-backed securities	2,496	98	—	2,594
Corporate debt securities	85,402	5,564	(40)	90,926
	115,344	7,858	(40)	123,162
Equity securities	8,478	290	—	8,768
	123,822	8,148	(40)	131,930
Held-to-maturity securities:				
Fixed maturities:				
Government securities	17,035	1,024	—	18,059
	\$ 140,857	\$ 9,172	\$ (40)	\$ 149,989

**December 31, 2009**

	<b>Cost and Amortized Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
Available-for-sale securities:				
Fixed maturities:				
Government securities	\$ 14,006	\$ 1,057	\$ —	\$ 15,063
Residential mortgage-backed securities	17,132	1,052	(36)	18,148
Commercial mortgage-backed securities	2,612	67	(155)	2,524
Corporate debt securities	73,988	3,645	(211)	77,422
	107,738	5,821	(402)	113,157
Equity securities	234	40	(2)	272
	107,972	5,861	(404)	113,429
Held-to-maturity securities:				
Fixed maturities:				
Government securities	16,539	706	(1)	17,244
	\$ 124,511	\$ 6,567	\$ (405)	\$ 130,673

F-14

[Table of Contents](#)

The following table summarizes the length of time securities with unrealized losses at December 31, 2010 have been in an unrealized loss position (in thousands).

	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Estimated Fair Value</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>	<b>Gross Unrealized Losses</b>
Available-for-sale securities:						
Fixed maturities:						
Corporate debt securities	\$ 4,976	\$ (40)	\$ —	\$ —	\$ 4,976	\$ (40)
	4,976	(40)	—	—	4,976	(40)
Equity securities	56	—	—	—	56	—
	\$ 5,032	\$ (40)	\$ —	\$ —	\$ 5,032	\$ (40)

For the year ended December 31, 2010, the Company took other-than-temporary impairments on two commercial mortgage-backed securities and recognized a loss in earnings of \$70,000. The Company liquidated one commercial mortgage-backed security in December 2010, and recognized an additional loss of \$13,000.

While all of the investments are monitored for potential other-than-temporary impairment, our experience indicated that other than those impaired, they generally do not present a great risk of impairment, as fair value historically recovers over time. Management believes that the analysis of each of these investments supports the view that these investments were not other-than-temporarily impaired. Evidence considered in



this analysis includes the reasons for the unrealized loss position, the severity and duration of the unrealized loss position, credit worthiness, and forecasted performance of the investee. While some of the securities held in the investment portfolio have decreased in value since the date of acquisition, the severity of loss and the steady recovery over time does not warrant other-than-temporary impairment of the securities. The Company does not intend to sell these securities and it is not likely that the Company will be required to sell these securities before the recovery of the cost basis and, therefore, does not believe any other-than-temporary impairments exist, except the other-than-temporary impairment on the aforementioned commercial mortgage backed securities, which occurred during the twelve months ended December 31, 2010.

Gross realized investment gains and losses for the year ended December 31, 2010, 2009 and 2008 are summarized as follows (in thousands).

	Twelve Months Ended December 31,								
	2010			2009			2008		
	Gross Gains	Gross Losses	Total	Gross Gains	Gross Losses	Total	Gross Gains	Gross Losses	Total
Fixed maturities	\$ 267	\$ (130)	\$ 137	\$ 503	\$ (1,226)	\$ (723)	\$ 433	\$ (1,669)	\$ (1,236)
Equity securities	—	—	—	1,032	(2)	1,030	—	(44,756)	(44,756)
	<u>\$ 267</u>	<u>\$ (130)</u>	<u>\$ 137</u>	<u>\$ 1,535</u>	<u>\$ (1,228)</u>	<u>\$ 307</u>	<u>\$ 433</u>	<u>\$ (46,425)</u>	<u>\$ (45,992)</u>

Sales of available-for-sale investment securities resulted in the following during the year ended December 31, 2010, 2009 and 2008 (in thousands).

	2010	2009	2008
Proceeds	\$ 16,726	\$ 23,647	\$ 39,829
Gross gains	\$ 267	\$ 1,535	\$ 433
Gross losses	\$ (130)	\$ (1,228)	\$ (46,425)

F-15

## [Table of Contents](#)

Expected maturities may differ from contractual maturities because certain borrowers may have the right to call or prepay obligations with or without penalties. The schedule of fixed maturities available-for-sale and held-to-maturity at December 31, 2010 and 2009 by contractual maturity is as follows (in thousands).

	December 31, 2010	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	\$ 8,228	\$ 8,420
Due after one year through five years	58,959	62,339
Due six years through ten years	33,588	36,668
Due after ten years	3,972	4,320
Mortgage-backed securities	10,597	11,415
	<u>\$ 115,344</u>	<u>\$ 123,162</u>
Held-to-maturity debt securities:		
Due within one year	\$ 201	\$ 204
Due after one year through five years	12,171	12,749
Due six years through ten years	4,663	5,106
	<u>\$ 17,035</u>	<u>\$ 18,059</u>
	December 31, 2009	
	Amortized Cost	Fair Value
Available-for-sale fixed maturities:		
Due within one year	\$ 3,416	\$ 3,455
Due after one year through five years	46,945	49,623
Due six years through ten years	38,736	40,546
Due after ten years	8,113	8,322
Mortgage-backed securities	10,528	11,211
	<u>\$ 107,738</u>	<u>\$ 113,157</u>
Held-to-maturity debt securities:		
Due within one year	\$ 3,364	\$ 3,408
Due after one year through five years	7,873	8,317
Due six years through ten years	5,302	5,519
	<u>\$ 16,539</u>	<u>\$ 17,244</u>

Net investment income for the year ended December 31, 2010, 2009, and 2008 is as follows (in thousands).

	Twelve Months Ended December 31,		
	2010	2009	2008
Cash equivalents	\$ 1,803	\$ 457	\$ 19,609
Fixed maturities	6,190	6,157	7,178
Equity securities	161	252	766
	8,154	6,866	27,553
Investment expenses	490	408	410
Net investment income	\$ 7,664	\$ 6,458	\$ 27,143

At December 31, 2010 and 2009, the Company had on deposit in custody for various State Insurance Departments investments with carrying values of approximately \$17.0 million and \$16.5 million, respectively.

F-16

## [Table of Contents](#)

### 4. Fair Value Measurements

The Company's estimates of fair value for financial assets and financial liabilities are based on the framework established in ASC 820, *Fair Value Measurements and Disclosures*. The framework is based on the inputs used in valuation and gives the highest priority to quoted prices in active markets and requires that observable inputs be used in the valuations when available. The disclosure of fair value estimates is based on whether the significant inputs into the valuation are observable. In determining the level of the hierarchy in which the estimate is disclosed, the highest priority is given to unadjusted quoted prices in active markets and the lowest priority to unobservable inputs that reflect the Company's significant market assumptions. The three levels of the hierarchy are as follows:

- Level 1 - Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.
- Level 2 - Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets; or valuations based on models where the significant inputs are observable (e.g., interest rates, yield curves, prepayment speeds, default rates, loss severities, etc.) or can be corroborated by observable market data.
- Level 3 - Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

The capital and credit markets have been experienced some degree of stability after a period of volatility and disruption. If the market were to worsen, there can be no assurance that we will not experience additional losses on our investments and reductions to earnings.

The following table presents the hierarchy used by the Company by asset and liability type to determine their value at December 31, 2010 and 2009 (in thousands).

	Twelve months ended December 31, 2010			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 649,439	\$ 649,439	\$ —	\$ —
Fixed Maturities				
Government securities	16,001		16,001	
Residential mortgage backed securities	13,641		13,641	
Commercial mortgage backed securities	2,594		2,594	
Corporate debt securities	90,926		90,926	
Equity securities				
Common stock	8,516	8,516		
Non-redeemable preferred stock	252	252		
Total	\$ 781,369	\$ 658,207	\$ 123,162	\$ —

	Twelve months ended December 31, 2009			
	Total	Level 1	Level 2	Level 3
Financial assets:				
Cash and cash equivalents	\$ 790,013	\$ 790,013	\$ —	\$ —
Fixed Maturities				
Government securities	15,064		15,064	
Residential mortgage backed securities	18,148		18,148	
Commercial mortgage backed securities	2,524		2,409	115
Corporate debt securities	77,421		77,421	
Equity securities				

Common stock	121	121		
Non-redeemable preferred stock	151	151		
Total	\$ 903,442	\$ 790,285	\$ 113,042	\$ 115

F-17

[Table of Contents](#)

**Level 1 financial assets**

The Company's Level 1 investments include cash and cash equivalent balances and actively-traded equity securities. Cash and cash equivalents are carried at amortized cost, which approximates fair value. Fair value of actively traded debt and equity securities are based on unadjusted quoted market prices. The Company receives the quoted market prices from a nationally recognized, third party pricing service.

**Level 2 financial assets**

When quoted market prices are unavailable, the Company utilizes a pricing service to determine an estimate of fair value, which is mainly used for its fixed maturity investments that include private and corporate debt securities, federal agency and municipal bonds, and non-government mortgage and asset-backed securities. The observable inputs utilized by the pricing service include interest rates, using either a market or income valuation approach to determine fair market value. The extent of the use of each market input depends on the asset class and the market conditions; and, for some securities, additional inputs may be necessary.

**Level 3 financial assets**

The Company's Level 3 fixed maturity securities include collateralized mortgage obligations. Fair values are based on inputs that are unobservable and significant to the overall fair value measurement, and involve management judgment. Inputs used to determine fair market value include market conditions, spread, volatility, structure and cash flows. The extent of the use of each market input depends on the asset class and the market conditions; and, for some securities, additional inputs may be necessary.

The following table includes a rollforward of the amounts at December 31, 2010 and 2009 for financial instruments classified within level 3. The classification of a financial instrument within level 3 is based upon the significance of the unobservable inputs to the overall fair value measurement.

	<u>Twelve Months Ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
Balance at January 1,	\$ 115	\$ 315
Net transfers in	—	1,888
Sales	(17)	(1,284)
Realized losses	(101)	—
Change in unrealized losses	3	(804)
Balance at December 31,	\$ —	\$ 115

During the year ended December 31, 2010, the Company sold two Level 3 securities, which were classified as commercial mortgage-backed securities. There were no transfers between Levels 1 and 2 during the year ended December 31, 2010. Realized losses relate to those financial instruments sold by the Company during the twelve months ended December 31, 2010.

During the year ended December 31, 2009, the Company had net transfers in of \$4.3 million, which were commercial mortgage-backed and corporate securities that were previously classified within Level 2 and transferred to Level 3. The Company sold two Level 3 securities for \$1.3 million. There were no transfers between Levels 1 and 2 during the year ended December 31, 2009. Net unrealized losses relate to those financial instruments held by the Company at December 31, 2009.

F-18

[Table of Contents](#)

The following table presents the fair value and carrying value of financial instruments not measured at fair value at December 31, 2010 and 2009 (in thousands):

	<u>December 31, 2010</u>		<u>December 31, 2009</u>	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Financial assets				
Held to maturity fixed maturities	\$ 17,035	\$ 18,059	\$ 16,539	\$ 17,244
Financial liabilities				
Notes payable	\$ 138,350	\$ 136,659	\$ 138,350	\$ 138,208

The fair value of notes payable is determined by market value and discounted cash flows.

## 5. Property and Equipment

The following summarizes property and other fixed assets as of December 31, 2010 and 2009 (in thousands).

	December 31,	
	2010	2009
Other equipment	\$ 824	\$ 824
Software	2,093	1,771
Less accumulated depreciation	(896)	(750)
	<u>\$ 2,021</u>	<u>\$ 1,845</u>

## 6. Deferred Acquisition Costs

Policy acquisition expenses, primarily commissions, premium taxes and underwriting expenses related to issuing a policy incurred by NLASCO are deferred and charged against income ratably over the terms of the related policies. The activity in deferred acquisition costs for the twelve months ended December 31, 2010 and 2009 is as follows (in thousands).

	Year Ended December 31,	
	2010	2009
Beginning of period deferred acquisition cost	\$ 15,745	\$ 15,935
Acquisition expenses capitalized	32,748	30,164
Amortization charged to income	(31,256)	(30,354)
	<u>\$ 17,237</u>	<u>\$ 15,745</u>

Amortization is included in policy acquisition and other underwriting expenses on the face of the income statement.

F-19

## [Table of Contents](#)

## 7. Goodwill and Intangible Assets

Goodwill and intangible assets for HTH represents the excess of the cost over the fair value of the assets of NLASCO. There were no impairments to goodwill for the years ended December 31, 2010 and 2009. The changes in the carrying amount of goodwill and indefinite lived intangible assets for the year ended December 31, 2010 and 2009 are as follows (in thousands).

	For the year ended December 31,			
	2010		2009	
	Goodwill	Indefinite Lived Intangibles	Goodwill	Indefinite Lived Intangibles
Balance at beginning of period	\$ 23,988	\$ 3,000	\$ 23,988	\$ 3,000
Balance at end of period	<u>\$ 23,988</u>	<u>\$ 3,000</u>	<u>\$ 23,988</u>	<u>\$ 3,000</u>

At December 31, 2010, we determined that no impairment existed with respect to goodwill and intangible assets. The Company tests goodwill and other intangible assets having an indefinite useful life for impairment on an annual basis on December 31, or more often if events or circumstances indicate there may be impairment. Goodwill impairment testing is performed at the reporting unit level, which is one level below an operating segment. Goodwill is assigned to reporting units at the date the goodwill is initially recorded. Once goodwill has been assigned to reporting units, it no longer retains its association with a particular acquisition, and all of the activities within a reporting unit, whether acquired or internally generated, are available to support the value of the goodwill. Management determined that HTH has two reporting units, which are the Parent (the holding company) and NLASCO (the insurance company).

The goodwill impairment analysis is a two-step test. The first step ("Step 1"), used to identify potential impairment, involves comparing each reporting unit's estimated fair value to its carrying value, including goodwill. If the estimated fair value of a reporting unit exceeds its carrying value, goodwill is considered not to be impaired. If the carrying value exceeds estimated fair value, there is an indication of potential impairment and the second step is performed to measure the amount of impairment. The Company has estimated fair values of reporting units based on both a market and income approach using historic, normalized actual and forecast results.

The second step ("Step 2") involves calculating an implied fair value of goodwill for each reporting unit for which the first step indicated impairment. The implied fair value of goodwill is determined in a manner similar to the amount of goodwill calculated in a business combination, by measuring the excess of the estimated fair value of the reporting unit, as determined in the first step, over the aggregate estimated fair values of the individual assets, liabilities and identifiable intangibles as if the reporting unit was being acquired in a business combination. If the implied fair value of goodwill exceeds the carrying value of goodwill assigned to the reporting unit, there is no impairment. If the carrying value of goodwill assigned to a reporting unit exceeds the implied fair value of the goodwill, an impairment charge is recorded for the excess. An impairment loss cannot exceed the carrying value of goodwill assigned to a reporting unit, and the loss establishes a new basis in the goodwill. Subsequent reversal of goodwill impairment losses is not permitted.

At December 31, 2010, we determined that the estimated fair value of our reporting units exceeded their carrying values and therefore we did not perform the second step as described above. Our fair value substantially exceeded carrying value by 233% as of December 31, 2010. Consequently, we determined that no impairment existed with respect to goodwill and intangible assets at December 31, 2010.

F-20

[Table of Contents](#)

The following table reflects the balances of our definite lived intangible assets at December 31, 2010 and 2009 (in thousands).

	<b>For the year ended December 31,</b>			
	<b>2010</b>		<b>2009</b>	
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>
Customer relationships	\$ 6,100	\$ (3,226)	\$ 6,100	\$ (2,524)
Agent relationships	3,600	(1,786)	3,600	(1,390)
Trade name	3,500	(914)	3,500	(670)
Software	1,500	(1,175)	1,500	(875)
<b>Total</b>	<b>\$ 14,700</b>	<b>\$ (7,101)</b>	<b>\$ 14,700</b>	<b>\$ (5,459)</b>

Future amortization of intangible assets for the next five years is as follows (in thousands):

2011	1,525
2012	1,132
2013	989
2014	872
2015	754
	<u>5,272</u>

Amortization for the year ended December 31, 2010 was \$1.6 million.

**8. Notes Payable**

The following table sets forth certain information regarding our debt in thousands.

	<b>Year Ended December 31,</b>	
	<b>2010</b>	<b>2009</b>
Senior exchangeable notes due 2025, 7.50% per annum	\$ 90,850	\$ 90,850
Insurance company line of credit due October 2011, base rate less 0.5% per annum	—	—
NLIC note payable due May 2033, three-month LIBOR plus 4.10% (4.40% at December 31, 2010)	10,000	10,000
NLIC note payable due September 2033, three-month LIBOR plus 4.05% (4.35% at December 31, 2010)	10,000	10,000
ASIC note payable due April 2034, three-month LIBOR plus 4.05% (4.35% at December 31, 2010)	7,500	7,500
Insurance company note payable due March 2035, three-month LIBOR plus 3.40% (3.70% at December 31, 2010)	20,000	20,000
	<u>\$ 138,350</u>	<u>\$ 138,350</u>

F-21

[Table of Contents](#)

**Senior Exchangeable Notes Due 2025**

In August 2005, our OP issued \$96.6 million aggregate principal amount of 7.50% senior exchangeable notes due 2025 to qualified institutional buyers in a private transaction. As of December 31, 2010, 90,850,000 were outstanding. The notes are senior unsecured obligations of the OP and are exchangeable, at the option of the holders, into shares of HTH common stock at an initial exchange rate of 69.8812 shares per \$1,000 principal amount of the notes (equal to an initial exchange price of approximately \$14.31 per share), subject to adjustment and, in the event of specified corporate transactions involving HTH or the OP, an additional make-whole premium. Upon exchange, the OP has the option to deliver, in lieu of shares of HTH common stock, cash or a combination of cash and shares of HTH common stock.

According to the terms of the notes, their initial exchange rate is adjusted for certain events, including the issuance to all holders of HTH



common stock of rights entitling them to purchase HTH common stock at less than their current market price. Accordingly, as a result of our rights offering in January 2007, in which we offered all holders of HTH common stock the right to purchase shares at \$8.00 per share, the initial exchange rate of the notes was adjusted to 73.95 shares per \$1,000 principal amount of the notes (equal to an initial exchange rate of \$13.52 per share).

Prior to August 20, 2015, the notes are not redeemable at the option of the OP. After August 20, 2015, the OP may redeem all or a portion of the notes at a redemption price equal to the principal amount plus accrued and unpaid interest, if any, on the notes, if the closing price of HTH common stock has exceeded 130% of the exchange price for at least 20 trading days in any consecutive 30-trading day period.

Holders of the notes may require the OP to repurchase all or a portion of the notes at a purchase price equal to the principal amount plus accrued and unpaid interest, if any, on the notes on each of August 15, 2010, August 15, 2015, and August 15, 2020, or after the occurrence of certain corporate transactions involving HTH or the OP. No Senior Notes were tendered to the Company prior to the expiration of the Put Right Purchase Offer, August 15, 2010.

#### Insurance Company Line of Credit

Our insurance subsidiary has a line of credit with a financial institution. The line allows for borrowings by NLASCO of up to \$5.0 million and is secured by substantially all of NLASCO's assets. The line of credit bears interest equal to a base rate, plus 3.75% (5.01% at December 31, 2010), which is due quarterly. This line is scheduled to mature in October 2011. There was no outstanding balance payable as of December 31, 2010.

#### NLIC Notes Payable

NLIC has two unsecured \$10 million notes payable to unaffiliated companies. The notes payable bear interest at three-month LIBOR plus 4.05% and three-month LIBOR plus 4.10% (4.40% and 4.35% at December 31, 2010). Interest is due quarterly and principal is due at maturity in September 2033 and May 2033, respectively. The notes are subordinated in right of payment to all policy claims and other indebtedness of NLIC. Further, all payments of principal and interest require the prior approval of the Insurance Commissioner of the State of Texas and are only payable to the extent that the statutory surplus of NLIC exceeds \$30 million.

#### ASIC Note Payable

ASIC has an unsecured \$7.5 million note payable to an unaffiliated company. The note payable bears interest at three-month LIBOR plus 4.05% (4.35% at December 31, 2010). Interest is due quarterly and principal is due at maturity in April 2034. The note is subordinated in right of payment to all policy claims and other indebtedness of ASIC. Further, all payments of principal and interest require the prior approval of the Insurance Commissioner of the State of Texas and are only payable to the extent that the statutory surplus of ASIC exceeds \$15 million.

#### Insurance Company Notes Payable

NLASCO has an unsecured \$20 million note payable to an unaffiliated company which bears interest equal to the three-month LIBOR plus 3.40% (3.70% at December 31, 2010). Interest is due quarterly and the principal is due at maturity in March 2035.

F-22

#### [Table of Contents](#)

NLASCO's loan agreements relating to the notes payable contain various covenants pertaining to limitations on additional debt, dividends, and officer and director compensation, and minimum capital requirements. The Company was in compliance with the covenants as of December 31, 2010.

NLASCO has entered into an indenture relating to the notes payable which provides that (i) if a person or group becomes the beneficial owner directly or indirectly of 50% or more of its equity securities and (ii) if NLASCO's ratings are downgraded by a nationally recognized statistical rating organization (as defined in the Securities Exchange Act of 1934, as amended, or the Exchange Act), then each holder of the notes governed by such indenture has the right to require that NLASCO purchase such holder's notes in whole or in part at a price equal to 107.5% of the outstanding principal amount prior to March 11, 2011, or 100.0% thereafter.

#### Note Payable Principal Maturities

The aggregate amount of annual principal maturities subsequent to December 31, 2010 is as follows (in thousands).

	Principal Commitments		
	Fixed	Variable	Total
2015 and Thereafter	90,850	47,500	138,350
Commitments	\$ 90,850	\$ 47,500	\$ 138,350

#### 9. Reserve for Unpaid Losses and Loss Adjustment Expenses

A roll-forward of the reserve for unpaid losses and loss adjustment expenses for the twelve months ended December 31, 2010 and 2009 are as follows (in thousands).

Year Ended December 31,

	2010	2009	2008
Balance at January 1,	\$ 33,780	\$ 34,023	\$ 18,091
Less reinsurance recoverables	(21,102)	(14,613)	(2,692)
Net balance at January 1,	12,678	19,410	15,399
Incurring related to:			
Current Year	69,044	71,509	80,726
Prior Period	1,899	(1,214)	(291)
Total incurred	70,943	70,295	80,435
Payments related to:			
Current Year	(59,560)	(61,372)	(66,522)
Prior Year	(8,952)	(15,655)	(9,902)
Total payments	(68,512)	(77,027)	(76,424)
Net balance at December 31,	15,109	12,678	19,410
Plus reinsurance recoverables	43,773	21,102	14,613
Balance at December 31,	\$ 58,882	\$ 33,780	\$ 34,023

The reserve for losses and loss adjustment expenses includes amounts that may be due to or from the sellers of NLASCO upon settlement in 2011 based on actual losses incurred applicable to the reserve as of the acquisition date. Incurred amounts related to prior year indicate that we were deficient in incurred but not reported as of December 31, 2009, resulting in an expense in the year ending December 31, 2010. This is due to adverse development on our homeowners and fire products for the 2009 accident year of \$1.0 million and \$0.5 million, respectively, due to an increase in frequency in our late reported claims. There was also an increase in all other expenses related to a 2008 catastrophe of \$0.6 million. For the year ended December 31, 2009, incurred amounts related to the year ended 2008 were redundant in incurred but not reported due to redundancy attributable to our homeowners product for the 2008 and prior accident years, which resulted in a benefit of \$1.2 million.

F-23

## [Table of Contents](#)

### 10. Reinsurance Activity

NLASCO limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risk. Substantial amounts of business are ceded, and these reinsurance contracts do not relieve NLASCO from its obligations to policyholders. Such reinsurance includes quota share, excess of loss, catastrophe, and other forms of reinsurance on essentially all property and casualty lines of insurance. Net premiums earned, losses and LAE and policy acquisition and other underwriting expenses are reported net of the amounts related to reinsurance ceded to other companies. Amounts recoverable from reinsurers related to the portions of the liability for losses and LAE and unearned premiums ceded to them are reported as assets. Failure of reinsurers to honor their obligations could result in losses to NLASCO; consequently, allowances are established for amounts deemed uncollectible as NLASCO evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 2010, reinsurance receivables have a carrying value of approximately \$45.7 million. There was no allowance for uncollectible accounts as of December 31, 2010, based on our quality requirements.

Reinsurers with a balance in excess of 5% of our outstanding receivables at December 31, 2010 are listed below (in thousands):

	<b>Balances due from Reinsurance Companies</b>	
Federal Emergency Management Agency	\$	5,974
Endurance Specialty Insurance Ltd		5,621
Ariel Reinsurance Company Limited		4,737
Platinum Underwriters Reinsurance, Inc.		4,258
Munich Reinsurance America, Inc		2,798
MS Frontier Reinsurance Limited		2,798
Arch Reinsurance Company		2,978
	\$	29,164

The effect of reinsurance on premiums written and earned for the year ended December 31, 2010 and 2009 is as follows (in thousands):

	Year Ended December 31, 2010		Year Ended December 31, 2009	
	Written	Earned	Written	Earned
Premiums from direct business	\$ 139,290	\$ 134,701	\$ 131,309	\$ 131,451
Reinsurance assumed	5,079	4,998	4,898	5,061
Reinsurance ceded	(22,678)	(22,507)	(21,464)	(21,359)
Net premiums	\$ 121,691	\$ 117,192	\$ 114,743	\$ 115,153

The effect of reinsurance on incurred losses was as follows:

	Year Ended December 31, 2010	Year Ended December 31, 2009
Loss and Loss Adjustment (LAE) expense incurred	\$ 109,882	\$ 96,477
Reinsurance recoverables	(38,939)	(26,182)
Net loss and LAE incurred	\$ 70,943	\$ 70,295

### Multi-line excess of loss coverage

In addition to the catastrophe reinsurance noted above, both NLIC and ASIC participate in an excess of loss program with General Reinsurance Corporation. The General Reinsurance Corporation program is limited to each risk with respect to property and liability in the amount of \$800,000 for each of NLIC and ASIC. Each of NLIC and ASIC retain \$200,000 in this program.

F-24

## [Table of Contents](#)

### Catastrophic coverage

NLASCO's liabilities for losses and loss adjustment expenses include liabilities for reported losses, liabilities for incurred but not reported, or IBNR, losses and liabilities for loss adjustment expenses, or LAE, less a reduction for reinsurance recoverables related to those liabilities. The amount of liabilities for reported claims is based primarily on a claim-by-claim evaluation of coverage, liability, injury severity or scope of property damage, and any other information considered relevant to estimating exposure presented by the claim. The amounts of liabilities for IBNR losses and LAE are estimated on the basis of historical trends, adjusted for changes in loss costs, underwriting standards, policy provisions, product mix and other factors. Estimating the liability for unpaid losses and LAE is inherently judgmental and is influenced by factors that are subject to significant variation. Liabilities for LAE are intended to cover the ultimate cost of settling claims, including investigation and defense of lawsuits resulting from such claims. Based upon the contractual terms of the reinsurance agreements, reinsurance recoverables offset, in part, NLASCO's gross liabilities.

As of December 31, 2010, NLASCO had five levels of catastrophic excess of loss reinsurance providing for coverage up to \$170.0 million through June 30, 2011 above \$1.0 million in retention for ASIC and \$6.0 million for NLIC. Total retention for any one catastrophe that affects both NLIC and ASIC is limited to \$6 million in the aggregate. NLASCO has an automatic reinstatement provision after the first loss for each layer to provide coverage in the event of subsequent catastrophes during the year. Coverage will lapse after the second or third event depending on the coverage layer, in which case NLASCO will evaluate the need for a new contract for the remainder of the year. During 2010, all five layers can be reinstated one time for 100% of the original premium.

As of January 1, 2011, the Company renewed its reinsurance contract for its first and second layers of reinsurance. Per the contract renewal, the Company increased its retention at NLIC to \$8 million; therefore, NLIC will have reinsurance for up to \$162 million in losses per event in excess of \$8 million retention. ASIC expanded its underlying coverage to \$7 million excess of \$1 million retention to correspond with the increased NLIC retention. The reinsurance in excess of \$8 million is comprised of four layers of protection: \$17 million in excess of \$8 million retention; \$25 million in excess of \$25 million loss; \$90 million in excess of a \$50 million loss; and \$30 million in excess of a \$140 million loss (the two upper layers also comprise a \$120 million in excess of \$50 million layer). NLIC and ASIC retains no participation in any of the layers, other than the first \$8 million and \$1 million retention, respectively.

For the year ended December 31, 2010, the Company experienced one significant catastrophe that resulted in losses in excess of retention at ASIC. As of December 31, 2010, the total loss and loss adjustment expenses incurred associated with the 2010 catastrophe was \$3.7 million; however, since the losses exceeded retention, net exposure to the Company was \$1.0 million in retention and \$0.5 million in reinstatement premiums.

For the year ended December 31, 2010, the ultimate loss development related to Hurricane Ike increased \$25.0 million, resulting in additional reinstatement premiums of \$1.1 million. Total loss development on Hurricane Dolly increased \$3.9 million, resulting in additional reinstatement premiums of \$0.9 million.

For the year ended December 31, 2009, the ultimate reserves for incurred by not reported losses related to Hurricane Ike increased \$22.0 million, resulting in additional reinstatement premiums of \$0.9 million.

For the year ended December 31, 2008, the Company experienced three significant catastrophes that resulted in losses in excess of retention. As of December 31, 2008, the total loss and loss adjustment expenses incurred associated with Hurricane Dolly was \$6.5 million; however, since the losses exceeded retention, net exposure to the Company was \$6.0 million in retention and \$71,000 in reinstatement premiums. Total loss and loss adjustment expenses incurred associated with Hurricane Gustav was \$3.5 million; however, since the losses exceeded retention, net exposure to the Company was \$1.0 million in retention and \$459,000 in reinstatement premiums. Total loss and loss adjustment expenses incurred associated with Hurricane Ike was \$72.9 million; however, since the losses exceeded retention, net exposure to the Company was \$6.0 million in retention and \$6.4 million in reinstatement premiums.

### 11. Income Taxes

At December 31, 2010, the Company had net operating loss carry-forwards for Federal income tax purposes, subject to certain limitations, of approximately \$45.3 million and \$49.0 million for regular income tax and alternative minimum tax, respectively. These net operating loss carry-forwards expire in 2018 through 2026. The net operating loss carry-forwards for alternative minimum Federal income taxes generally are limited to offsetting 90% of the alternative minimum taxable earnings for a given period.

[Table of Contents](#)

As of December 31, 2010, we had a net deferred tax asset, net of liabilities, of \$9.1 million. Our 35% statutory rate reflects the expectation that future taxable income of our insurance business will primarily be subject to Federal but not state income taxes. Our effective tax rate is subject to prior year state tax audit adjustments. The Company is generally not subject to state income taxes after 2007. Insurance companies are generally not taxed in most states on income taxes as they pay premium taxes in states where they generate premium revenue.

GAAP requires the measurement of uncertain tax positions. Uncertain tax positions are the difference between a tax position taken, or expected to be taken in a tax return, and the benefit recognized for accounting purposes. For the period ending December 31, 2010 we had the following uncertain tax benefit. The change in our unrecognized tax benefit is a result of the resolution of open state tax audits.

	December 31, 2010	December 31, 2009
Balance at beginning of year	\$ 1,167	\$ —
Tax positions of prior years	(207)	1,167
Balance at end of year	\$ 960	\$ 1,167

We have weighted the potential effect of both the negative and positive evidence in accordance with ASC 740-10-30-23 and have concluded that a valuation allowance is not necessary at this time. The unusual and infrequent nature of the events that led to net losses in 2008 and 2009, as well as the forecast supporting the future income of the Company resulting in the utilization of the deferred tax asset, is the primary support in our conclusion. We will however continue to monitor the utilization of the deferred tax asset and be cognizant of a triggering event that may lead to a reconsideration of a valuation allowance in the future.

[Table of Contents](#)

We file tax returns as prescribed by the tax laws of the jurisdictions in which we operate. We are subject to tax audits in numerous jurisdictions in the U.S. until the applicable statute of limitation expire. The following is a summary of the tax years open to examination:

U.S. Federal—2007 through 2009

U.S. States—2006 through 2009

As of December 31, 2010, the Company is under a Federal income tax audit for the years 2007 through 2009. The Company expects no material impact on its financials as a result of this Federal tax audit.

Under special IRS rules (the “Section 382 Limitation”), cumulative stock purchases by 5% shareholders exceeding 50% during a three year period can limit a company’s future use of net operating losses (NOL’s). We had a Section 382 ownership change in February 2004 at the time of the IPO.

The significant components of the provision for income taxes are as follows (in thousands):

	For the Year Ended December 31,		
	2010	2009	2008
Current tax benefit	\$ 1,125	\$ 2,325	\$ 26,800
Deferred tax expense	(118)	(976)	(11,844)
Allowance	—	—	4,603
Income tax benefit	\$ 1,007	\$ 1,349	\$ 19,559

The provision for income taxes differs from the amount that would be computed by applying the statutory Federal income tax rate of 35% to income before income taxes as a result of the following (in thousands):

	For the Year Ended December 31,		
	2010	2009	2008
Tax benefit at statutory rate	\$ 544	\$ 1,211	\$ 14,751
Permanent differences	(124)	(1)	205
State taxes	587	139	—
Decrease in valuation allowance	—	—	4,603
Income tax benefit	\$ 1,007	\$ 1,349	\$ 19,559

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The tax effects of significant temporary differences that give rise to the net deferred tax assets and liabilities are as follows (in thousands):

	December 31, 2010	December 31, 2009
<b>Deferred Tax Assets</b>		
Net operating loss carryforwards	\$ 15,851	\$ 15,850
Accrued liabilities and other	856	2,269
Loss and loss adjustment expense discounting	371	304
Unearned premiums	4,868	4,439
Contribution	6	—
Loan origination costs	338	371
Rental and other property, net	33	36
AMT credit carryforward	769	769
Total gross deferred tax assets	<u>\$ 23,092</u>	<u>\$ 24,038</u>
<b>Deferred Tax Liabilities</b>		
Intangible assets	\$ 3,710	\$ 4,284
Goodwill	407	307
Investments	989	495
Securities available for sale	2,838	1,910
Deferred policy acquisition costs	6,033	5,511
Total gross deferred tax liabilities	<u>\$ 13,977</u>	<u>\$ 12,507</u>
Net Deferred Tax Asset	<u>\$ 9,115</u>	<u>\$ 11,531</u>

## 12. Common Stock, Preferred Stock, Dividends and Minority Interest Related Transactions

### *Common Stock*

In accordance with ASC 718, *Compensation — Stock Compensation*, total compensation expense recorded in general and administrative expenses for the years ended December 31, 2010, 2009 and 2008 related to stock-based compensation was \$0.1 million, \$0.1 million and \$0.2 million, respectively. Stock compensation expense is included as part of additional paid-in capital on the consolidated balance sheets.

As of December 31, 2010, the Company has no outstanding warrants. The outstanding unexercised warrants expired July 23, 2010.

On October 25, 2007, the Compensation Committee of our Board of Directors approved the grant of an aggregate 100,000 non-qualified stock option awards to two senior executive officers of the Company pursuant to our 2003 Equity Incentive Plan at an exercise price of \$12.06 per share, the closing price of HTH's common stock on the New York Stock Exchange on the date of grant. The options have a term of five years from the date of the award. Under the terms of the grants, 20% of the options vested on the grant date, and the balance of the options vest ratably over a four-year period with 20% of the award amount vesting on the first anniversary of the award and 20% each anniversary thereafter. Vesting is accelerated in certain circumstances, including in the event of the death of the award recipient or in the event of a change of control of the Company. The fair value for the stock options granted during the year ended December 31, 2007 were estimated using the Black-Scholes option pricing model with an expected volatility of 25%, a risk-free interest rate of 4.0%, a dividend yield rate of zero, a five-year expected life of the options, and a forfeiture rate of fifteen percent. Based on calculations using the Black-Scholes option pricing model, the grant date fair value of the options granted during the quarter approximated \$3.10 per share. The expected volatility is based on the historical volatility in the price of our common stock since our IPO. The risk-free interest rate is the five-year Treasury rate, based on the term of the options. The dividend yield assumption is based on our history and expectation of dividend payments on common stock. The expected life of the stock options represents the period in which the stock options are expected to remain outstanding.

During 2010, 2009 and 2008, we granted 10,163, 12,359 and 15,282 common shares, respectively, to independent members of our board of directors for service rendered to the Company during the periods.

### *Preferred Stock*

In 2004, the Company issued 5,000,000 shares of Series A preferred stock at an initial public offering price of \$25.00 per share that have no stated par value and a liquidation preference of \$25.00 per share, plus all accumulated, accrued and unpaid dividends. The holders of our Series A preferred stock are entitled to receive cash dividends at a rate of 8.25% per annum on the \$25.00 liquidation preference. The Series A preferred stock has no voting rights and no stated maturity. On and after February 18, 2009, we had the option to redeem our Series A preferred stock, in whole or from time to time in part, at a cash redemption price equal to \$25.00 per share, plus all accumulated, accrued and unpaid dividends, if any, to and including the redemption date.



On August 6, 2010, the Company called for redemption all of the outstanding shares of its Series A Preferred Stock. The Series A Preferred Stock was redeemed on September 6, 2010, at a cash redemption price of \$25.2063 per share, representing the liquidation preference of \$25.00 per share, plus accrued and unpaid dividends to, and including, the date of redemption.

On December 20, 2010, the Company filed Articles Supplementary with the Department of Assessments and Taxation of the State of Maryland, which was effective upon filing. The Articles Supplementary reclassified and designated 750,000 authorized but unissued shares of the 8.25% Series A Cumulative Redeemable Preferred Stock of the Company as authorized but unissued shares of preferred stock of the Company. Accordingly, following the redemption and filing of the Articles Supplementary, the Company has 10,000,000 shares of authorized but unissued shares of preferred stock, none of which are classified or designated.

#### Dividends

The following table sets forth the cash dividends declared and paid in 2010 and 2009:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>Series A Preferred Stock</b>				
<b>2010</b>				
Date of declaration	March 17, 2010	July 8, 2010	August 6, 2010	N/A
Date of record	April 15, 2010	July 15, 2010	September 6, 2010	N/A
Date paid	April 30, 2010	July 30, 2010	September 6, 2010	N/A
Distribution per unit	\$ 0.5156	\$ 0.5156	\$ 0.2063	N/A
Total dollars (in thousands)	\$ 2,578	\$ 2,578	\$ 1,032	N/A
<b>2009</b>				
Date of declaration	March 16, 2009	July 6, 2009	September 15, 2009	December 10, 2009
Date of record	April 15, 2009	July 15, 2009	October 15, 2009	January 15, 2010
Date paid	April 30, 2009	July 30, 2009	October 30, 2009	January 29, 2010
Distribution per unit	\$ 0.5156	\$ 0.5156	\$ 0.5156	\$ 0.5156
Total dollars (in thousands)	\$ 2,578	\$ 2,578	\$ 2,578	\$ 2,579

F-29

#### [Table of Contents](#)

### 13. General and Administrative Expense

During the years ended December 31, 2010, 2009 and 2008, we incurred general and administrative expense as follows (in thousands):

	Year Ended December 31,		
	2010	2009	2008
Salaries and benefits	\$ 1,760	\$ 2,269	\$ 2,009
Travel	31	46	76
Professional services	3,682	2,753	3,983
Management fees	1,123	1,224	1,200
Insurance	567	566	568
Rent	10	47	51
Other administrative expense	260	249	228
	\$ 7,433	\$ 7,154	\$ 8,115

### 14. Employee Savings Plan

We provide our employees a qualified retirement savings plan, or Plan, designed to qualify under Section 401 of the Internal Revenue Code. The Plan allows our employees and employees of our subsidiaries to defer a portion of their compensation on a pre-tax basis subject to certain maximum amounts. The Plan provides for matching contributions to be made by us to employee accounts at the rate of 100% of the first 3% of compensation and 50% of the next 2% of compensation. For the years ended December 31, 2010, 2009 and 2008, the Company match was \$ 0.1 million, \$0.1 million and \$0.1 million.

### 15. Related Party Transactions

Pursuant to a Management Services Agreement, as amended, Diamond A Administration Company LLC, or Diamond A, an affiliate of Gerald J. Ford, the current Chairman of the Board of Hilltop and the beneficial owner of 26.6% of Hilltop common stock as of December 31, 2010, provides certain management services to Hilltop and its subsidiaries, including, among others, financial and acquisition evaluation, and office space to Hilltop. The services and office space are provided at a cost of \$91,500 per month, plus reasonable out-of-pocket expenses. The services provided under this agreement include those of several Hilltop's directors, including Gerald J. Ford, Kenneth Russell and Carl B. Webb. Prior to Jeremy Ford assuming the role of Chief Executive Officer of Hilltop, he provided services to Hilltop under the Management Services Agreement. The Management Services Agreement continues in effect until terminated by either party upon thirty days prior written notice to the other party for any or no reason whatsoever or at such time as may be mutually agreed by the parties. Hilltop also agreed to indemnify and hold harmless Diamond A for its performance or provision of these services, except for gross negligence and willful misconduct. Further, Diamond A's maximum aggregate liability for damages under this agreement is limited to the amounts paid to Diamond A under this agreement during twelve months prior

to that cause of action.

Jeremy B. Ford, a director and the Chief Executive Officer of Hilltop, is the beneficiary of a trust that owns a 49% limited partnership interest in Diamond A Financial, L.P. Diamond A Financial, L.P. owns 26.6% of the outstanding Hilltop common stock at December 31, 2010. He also is a director and the Secretary of Diamond A Administration Company, LLC, which provides management services to Hilltop under the Management Services Agreement described in the preceding paragraph. Diamond A Administration Company, LLC is owned by Hunter's Glen/Ford, Ltd., a limited partnership in which a trust for the benefit of Jeremy B. Ford is a 46% limited partner.

Jeremy B. Ford is the son of Gerald J. Ford. Corey G. Prestidge, Hilltop's General Counsel and Secretary, is the son-in-law of Gerald J. Ford. Accordingly, Messrs. Jeremy Ford and Corey Prestidge are brothers-in-law.

In 2009, we negotiated a consulting agreement with a related party consultant, who performs income tax consulting and is being paid \$80,000 per year instead of the original compensation that consisted of cash settled stock appreciation rights, or SARS, that vested ratably over a 5 year period and expires on December 12, 2012.

On March 8, 2007, the Company's board of directors appointed C. Clifton Robinson as a director of the Company. Mr. Robinson is the former chief executive officer of NLASCO. At the closing of the NLASCO acquisition, C. Clifton Robinson and his son, Gordon Robinson, the former vice chairman and deputy chief executive officer of NLASCO, entered into employment agreements with NLASCO. C. Clifton Robinson's employment agreement provides that he will serve as chairman of NLASCO and will be paid \$100,000 per year. Gordon Robinson's employment agreement provides that he will serve as a senior advisor to NLASCO and will be paid \$100,000 per year. Both employment agreements are for a one-year term and were not extended past January 31, 2011, with final payment being made in January 2011.

F-30

## [Table of Contents](#)

As part of the NLASCO acquisition, there will be a settlement of the reserves for losses and loss adjustment expense based on the runoff of the actual NLASCO loss reserves that were in existence and recorded on the NLASCO books and records as of the transaction closing date - January 31, 2007. A preliminary settlement occurred in February 2010 and the Company paid Mr. Robinson \$2.9 million net of taxes. The final settlement is to occur at a date estimated to be June 30, 2011. Depending on actual experience in disposition of these claims, additional payment would be due Mr. Robinson and related selling parties if claim settlement experience is favorable relative to the original amount reserved; or if claim settlement experience is unfavorable relative to the original reserves, Mr. Robinson and related selling parties would be required to reimburse the Company for any inadequate reserve. The additional payment to Mr. Robinson and related selling parties, or refund from Mr. Robinson and related selling parties, would be 65% of the variance of actual losses versus loss reserves in existence at the transaction closing date, plus 8% interest on this balance due, accruing from the date 18 months after the transaction closing date, July 31, 2008. At December 31, 2010, the Company estimates this is currently a payable to Mr. Robinson of \$0.3 million, and is reflected in our "Other Liabilities" on the consolidated Balance Sheet.

NLASCO and its affiliates in Waco, Texas lease office space from affiliates of Mr. Robinson, a member of Hilltop's Board of Directors. There are three separate leases. The first lease is a month-to-month lease for office space at a rate of \$900 per month. The second lease is a month-to-month lease at a monthly rental rate of \$3,500 per month. The first and second leases were terminated in August 2010. The third lease, as amended, currently requires payments of \$40,408 per month and expires on December 31, 2014, but does have renewal options at the discretion of the lessee. Aggregate office space under lease with regard to the foregoing is approximately 33,800 square feet.

## 16. Commitments and Contingencies

At December 31, 2010 the following table shows our outstanding commitments for leases (in thousands).

Lease Obligations	Payments Due by Period		
	Less than 1 year	1-3 years	Total
Total lease obligations	\$ 519	\$ 1,558	\$ 2,077

Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties and other sources are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

We are a party to various legal actions resulting from our operating activities. These actions consist of litigation and administrative proceedings arising in the ordinary course of business, some of which are covered by liability insurance, and none of which is expected to have a material adverse effect on our consolidated financial condition, results of operations or cash flows taken as a whole.

## 17. Statutory Net Income and Capital and Surplus

The Company's insurance subsidiaries, which are domiciled in the State of Texas, prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the Texas Department of Insurance, which Texas recognizes for determining solvency under Texas State Insurance Law. The Commissioner of the Texas Department of Insurance has the right to permit other practices that may deviate from prescribed practices. Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in Texas. Permitted statutory accounting practices encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. The Company's insurance subsidiaries have no such permitted statutory accounting practices.

The Company's insurance subsidiaries' statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the Texas Department of Insurance. Texas had adopted the National Association of Insurance Commissioners' statutory accounting practices as the basis of its statutory accounting practices with certain differences which are not significant to the company's statutory equity.

F-31

[Table of Contents](#)

Following is a summary of statutory capital and surplus and statutory net income of each insurance subsidiary for the year ended December 31, 2010, 2009 and 2008 (in thousands).

	Year Ended December 31,		
	2010	2009	2008
<b>National Lloyds Insurance Company</b>			
Surplus	\$ 94,081	\$ 89,767	\$ 84,343
Statutory net income (loss)	\$ 7,010	\$ 6,119	\$ (4,214)
<b>American Summit Insurance Company</b>			
Capital and surplus	\$ 25,216	\$ 27,555	\$ 24,135
Statutory net income	\$ 642	\$ 3,567	\$ 1,126

On October 29, 2010 and November 1, 2010, ASIC and NLIC, respectively, were notified by the Texas Department of Insurance that a statutory examination has been scheduled in the calendar year 2011/2012. The examination will be as of December 31, 2010, and cover the period since the last examination, which was as of December 31, 2006. We do not expect any significant changes to our financial statements as a result of the examinations by the domiciliary state.

**18. Capital and Dividend Restrictions**

The funding of the cash requirements (including debt service) of NLASCO is primarily provided by cash dividends from NLASCO's wholly-owned insurance subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the Texas Department of Insurance. Under Texas State Insurance Law for property and casualty companies, all dividends must be distributed out of earned surplus only. Furthermore, without the prior approval of the Commissioner, dividends cannot be declared or distributed which exceed the greater of ten percent of NLASCO's surplus, as shown by its last statement on file with the Commissioner, or one hundred percent of net income for such period. The subsidiaries paid \$14.0 million in March 2008, no dividends in 2009 and \$6.0 million in dividends to NLASCO in 2010. At December 31, 2010, the maximum dividend that may be paid to NLASCO in 2011 without regulatory approval is approximately \$11.9 million.

Regulations of the Texas Department of Insurance require insurance companies to maintain minimum levels of statutory surplus to ensure their ability to meet their obligations to policyholders. At December 31, 2010, the Company's insurance subsidiaries had statutory surplus in excess of the minimum required.

Also, the NAIC has adopted the RBC formula for insurance companies that establishes minimum capital requirements relating to insurance risk, asset credit risk, interest rate risk and business risk. The formula is used by the NAIC and certain state insurance regulators as an early warning tool to identify companies that require additional scrutiny or regulatory action. At December 31, 2010, the Company's insurance subsidiaries' RBC ratio exceeded the level at which regulatory action would be required.

F-32

[Table of Contents](#)

**19. (Loss) Income per Share**

The following reflects the calculation of loss per share on a basic and diluted basis (in thousands, except per share information):

	Year Ended December 31,		
	2010	2009	2008
<b>Loss per share available to common stockholders:</b>			
Loss from operations	\$ (548)	\$ (2,112)	\$ (22,585)
Preferred stock dividends	(7,047)	(10,313)	(10,313)
Redemption of preferred stock	(5,892)	—	—
Loss available to common stockholders	<u>\$ (13,487)</u>	<u>\$ (12,425)</u>	<u>\$ (32,898)</u>
Basic loss per share to common stockholders	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>
Diluted loss per share to common stockholders	<u>\$ (0.24)</u>	<u>\$ (0.22)</u>	<u>\$ (0.58)</u>
<b>Weighted average share information:</b>			
Basic shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>
Diluted shares outstanding	<u>56,492</u>	<u>56,474</u>	<u>56,453</u>

Weighted average equivalent shares excluded from diluted loss per share because they would be anti-dilutive:			
Stock warrants	—	1	1
Senior exchangeable Notes	6,718	6,718	6,718
Stock options	100	516	541
Total	6,818	7,235	7,260

## 20. Segments

NLASCO operates through its wholly-owned subsidiaries, NLIC and ASIC. Given the homogenous nature of our products, the regulatory environments in which we operate, the nature of our customers and our distribution channels, we now monitor, control and manage our business lines as an integrated entity providing fire and homeowners insurance to low value dwellings and manufactured homes primarily in Texas and other areas of the south, southeastern and southwestern United States. Accordingly, we only have insurance segment information to disclose.

## 21. Subsequent Events

Consistent with GAAP for subsequent events, Hilltop Holdings Inc. has evaluated subsequent events through the date of filing of its report on Form 10-K for the year ended December 31, 2010 with the SEC, and has no material subsequent events to report.

F-33

## [Table of Contents](#)

## 22. Quarterly Financial Information (Unaudited)

The following is quarterly financial information for the years ended December 31, 2010 and 2009 (in thousands except per share data):

	Quarter ended			
	Mar 31	Jun 30	Sep 30	Dec 31
<b>For the quarters ended 2010:</b>				
Total revenue	\$ 31,655	\$ 32,870	\$ 33,878	\$ 33,334
Total expenses	\$ 30,899	\$ 36,857	\$ 32,993	\$ 32,543
Net (loss) income	\$ (2,087)	\$ (5,207)	\$ (7,219)	\$ 1,026
Basic (loss) income per share	\$ (0.04)	\$ (0.09)	\$ (0.13)	\$ 0.02
Diluted (loss) income per share	\$ (0.04)	\$ (0.09)	\$ (0.13)	\$ 0.02
<b>For the quarters ended 2009:</b>				
Total revenue	\$ 31,704	\$ 31,287	\$ 32,681	\$ 33,163
Total expenses	\$ 29,638	\$ 44,110	\$ 30,062	\$ 28,486
Net (loss) income	\$ (1,222)	\$ (10,909)	\$ (896)	\$ 602
Basic (loss) income per share	\$ (0.02)	\$ (0.19)	\$ (0.02)	\$ 0.01
Diluted (loss) income per share	\$ (0.02)	\$ (0.19)	\$ (0.02)	\$ 0.01

Total revenue for the quarter ended March 31, 2010 and 2009 was \$31.7, respectively. Net premiums earned were \$28.1 million for the first quarter in 2010, as compared to \$28.4 million for the same period in 2009. Net investment income was \$1.6 million for the first quarter of 2010, as compared to \$1.8 million for the same period in 2009, primarily due to higher yields on cash balances in 2009. We had a net realized gain on investments of \$0.1 million in the first quarter of 2010 and 2009. Other income was \$1.8 million for the first quarter in 2010, as compared to \$1.5 million for the first quarter in 2009, due to an increase in service fees from policies that include wind coverage in hurricane prone areas.

Total expenses for the quarter ended March 31, 2010 were \$30.9 million as compared to \$29.6 million for the same period in 2009. The increase is due to an increase in loss and LAE expenses for the quarter ended March 31, 2010 of \$1.5 million, which was due to higher wind and hail losses as compared to the quarter ended March 31, 2009.

Total revenue for the quarter ended June 30, 2010 was \$32.9 million as compared to \$31.2 million for the quarter ended June 30, 2009. Net premiums earned were \$29.3 million for the three months ended June 30, 2010, as compared to \$28.7 million for the same period in 2009. Net investment income was \$1.9 million for the three months ended June 30, 2010, as compared to \$1.7 million for the same period in 2009. Net realized losses on investments were \$51,000 in the three months ended June 30, 2010, compared to a net realized loss of \$0.9 million for the same period in 2009. In June 2009, the Company impaired one corporate bond, which resulted in a loss of \$0.8 million. Other income was \$1.8 million for the three months ended June 30, 2010 and 2009.

Total expenses for the quarter ended June 30, 2010 were \$36.9 million as compared to \$44.1 million for the quarter ended June 30, 2009. The decrease is mostly due to a \$7.6 million decrease in loss and lae expenses in the quarter ended June 30, 2010 as compared to June 30, 2009, which was a result of lower frequency and severity of wind, hail and fire losses.

Total revenue for the three months ended September 30, 2010 was \$33.9 million, as compared to \$32.7 million for the same period in 2009. Net premiums earned were \$30.1 million for the three months ended September 30, 2010, as compared to \$29.2 million for 2009. Net investment income was \$2.0 million for the three months ended September 2010, as compared to \$1.5 million for the same period in 2009. Other income was \$1.6 million for the third quarter in 2010, as compared to \$1.9 million for 2009.

Total expenses for the quarter ended September 30, 2010 were \$33.0 million as compared to \$30.1 million for the quarter ended 2009. The increase is primarily due to an increase in frequency and severity of fire losses, partially offset by a decrease in wind and hail losses.

Total revenue for the three months ended December 31, 2010 was \$33.3 million as compared to \$33.2 million for the same period in 2009. The increase is primarily due to increases in net premiums earned of \$0.7 million, net investment income of \$0.6 million, offset by decreases in other income of \$0.2 million and net realized investment gains of \$1.0 million.

Total expenses for the quarter ended December 31, 2010 was \$32.5 million as compared to \$28.4 million for the quarter ended December 31, 2009. This increase is due to an increase in loss and LAE expenses of \$4.1 million related to increased severity in wind and hail losses.

F-34

[Table of Contents](#)

**Schedule I - Schedule of Investments - Other than Investments in Related Parties**  
(in thousands)

Type of Investment	December 31, 2010		
	Cost	Market Value	Balance Sheet
<b>Fixed maturities:</b>			
<b>Bonds:</b>			
Unites States Government and government agencies and authorities	\$ 16,751	\$ 17,746	\$ 16,913
States, municipalities and political subdivisions	33,336	35,915	35,724
All other	82,292	87,561	87,560
Total fixed maturities	\$ 132,379	\$ 141,222	\$ 140,197
<b>Equity securities:</b>			
Industrial, miscellaneous, and all other	\$ 8,227	\$ 8,516	\$ 8,516
Preferred Stock	251	252	252
Total equity securities	8,478	8,768	8,768
Total investments	\$ 140,857	\$ 149,990	\$ 148,965

F-35

[Table of Contents](#)

**Schedule IV - Reinsurance**  
(in thousands)

Premiums Earned	For the Year Ended December 31, 2010
Gross premiums	\$ 134,701
Ceded to other companies	(22,507)
Assumed from other companies	4,998
Net Premiums	\$ 117,192
Percentage of amount assumed to net	4.26%
Premiums Earned	For the Year Ended December 31, 2009
Gross premiums	\$ 131,451
Ceded to other companies	(21,359)
Assumed from other companies	5,061
Net Premiums	\$ 115,153
Percentage of amount assumed to net	4.40%

F-36

[\(Back To Top\)](#)

**Section 2: EX-3.1 (EX-3.1)**



**AFFORDABLE RESIDENTIAL COMMUNITIES INC.****ARTICLES OF AMENDMENT AND RESTATEMENT**

*FIRST:* Affordable Residential Communities Inc., a Maryland corporation (the “Corporation”), desires to amend and restate its charter as currently in effect and as hereinafter amended.

*SECOND:* The following provisions are all the provisions of the charter currently in effect and as hereinafter amended:

**ARTICLE I****INCORPORATOR**

The undersigned, James J. Hanks, Jr., whose address is c/o Venable LLP, 2 Hopkins Plaza, Suite 1800, Baltimore, Maryland 21201, being at least 18 years of age, does hereby form a corporation under the general laws of the State of Maryland.

**ARTICLE II****NAME**

The name of the corporation (the “Corporation”) is:

Affordable Residential Communities Inc.

**ARTICLE III****PURPOSE**

The purposes for which the Corporation is formed are to engage in any lawful act or activity (including, without limitation or obligation, engaging in business as a real estate investment trust under the Internal Revenue Code of 1986, as amended, or any successor statute (the “Code”)) for which corporations may be organized under the general laws of the State of Maryland as now or hereafter in force. For purposes of these Articles, “REIT” means a real estate investment trust under Sections 856 through 860 of the Code.

**ARTICLE IV****PRINCIPAL OFFICE IN STATE AND RESIDENT AGENT**

The address of the principal office of the Corporation in the State of Maryland is c/o Venable LLP, 2 Hopkins Plaza, Suite 1800, Baltimore, Maryland 21201. The name of the resident agent of the Corporation in the State of Maryland is James J. Hanks, Jr., whose post office address is c/o Venable LLP, 2 Hopkins Plaza, Suite 1800, Baltimore, Maryland 21201. The resident agent is a citizen of and resides in the State of Maryland.

**ARTICLE V**

**PROVISIONS FOR DEFINING, LIMITING  
AND REGULATING CERTAIN POWERS OF THE  
CORPORATION AND OF THE STOCKHOLDERS AND DIRECTORS**

Section 5.1 *Number and Qualification of Directors.* The business and affairs of the Corporation shall be managed under the direction of the Board of Directors. The number of directors of the Corporation shall be eleven, which number may be increased or decreased pursuant to the Bylaws, but shall never be less than the minimum number required by the Maryland General Corporation Law (the

“MGCL”) nor more than 15. The names of the directors who shall serve until the next annual meeting of stockholders and until their successors are duly elected and qualify are:

Scott D. Jackson  
John G. Sprengle  
Todd M. Abbrecht  
James L. Clayton  
J. Markham Green  
Michael Greene  
Thomas M. Hagerty  
Randall A. Hack  
Eugene Mercy, Jr.  
Charles J. Santos-Buch  
Scott A. Schoen

Subject to the provisions of this Section 5.1, these directors may increase the number of directors and may fill any vacancy, whether resulting from an increase in the number of directors or otherwise, on the Board of Directors occurring before the next annual meeting of stockholders in the manner provided in the Bylaws.

The Corporation elects, at such time as it becomes eligible to make the election provided for under Section 3-802(b) of the MGCL, that, except as may be provided by the Board of Directors in setting the terms of any class or series, any and all vacancies on the Board of Directors may be filled only by the affirmative vote of a majority of the remaining directors in office, even if the remaining directors do not constitute a quorum, and any director elected to fill a vacancy shall serve for the remainder of the full term of the directorship in which such vacancy occurred.

Section 5.2 *Extraordinary Actions.* Except as specifically provided in Section 5.8 (relating to removal of directors) and in Article VIII, notwithstanding any provision of law permitting or requiring any action to be taken or approved by the affirmative vote of the holders of shares entitled to cast a greater number of votes, any such action shall be effective and valid if taken or approved by the affirmative vote of holders of shares entitled to cast a majority of all the votes entitled to be cast on the matter.

Section 5.3 *Authorization by Board of Stock Issuance.* The Board of Directors may authorize the issuance from time to time of shares of stock of the Corporation of any class or series, whether now or hereafter authorized, or securities or rights convertible into shares of its stock of any class or series, whether now or hereafter authorized, for such consideration as the Board of Directors may deem advisable (or without consideration in the case of a stock split or stock dividend), subject to such restrictions or limitations, if any, as may be set forth in the charter of the Corporation (the "Charter") or the Bylaws.

Section 5.4 *Preemptive Rights and Appraisal Rights.* Except as may be provided by the Board of Directors in setting the terms of classified or reclassified shares of stock pursuant to Section 6.5 or as may otherwise be provided by contract, no holder of shares of stock of the Corporation shall, as such holder, have any preemptive right to purchase or subscribe for any additional shares of stock of the Corporation or any other security of the Corporation which it may issue or sell. Holders of shares of stock shall not be entitled to exercise any rights of an objecting stockholder provided for under Title 3, Subtitle 2 of the MGCL unless the Board of Directors, upon the affirmative vote of a majority of the entire Board of Directors, shall determine that such rights apply, with respect to all or any classes or series of stock, to a particular transaction or all transactions occurring after the date of such determination in connection with which holders of such shares would otherwise be entitled to exercise such rights.

Section 5.5 *Indemnification.* The Corporation shall have the power, to the maximum extent permitted by Maryland law in effect from time to time, to obligate itself to indemnify, and to pay or reimburse reasonable expenses in advance of final disposition of a proceeding to, (a) any individual who is a present or former director or officer of the Corporation or (b) any individual who, while a director or officer of the Corporation and at the request of the Corporation, serves or has served as a director, officer, partner or trustee of another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or any other enterprise from and against any claim or liability to which such person may become subject or which such person may incur by reason of his status as a present or former director or officer of the Corporation. The Corporation shall have the power, with the approval of the Board of Directors, to provide such indemnification and advancement of expenses to a person who served a predecessor of the Corporation in any of the capacities described in (a) or (b) above and to any employee or agent of the Corporation or a predecessor of the Corporation.

Section 5.6 *Determinations by Board.* The determination as to any of the following matters, made in good faith by or pursuant to the direction of the Board of Directors consistent with the Charter and in the absence of actual receipt of an improper benefit in money, property or services or active and deliberate dishonesty established by a court, shall be final and conclusive and shall be binding upon the Corporation and every holder of shares of its stock: the amount of the net income of the Corporation for any period and the amount of assets at any time legally available for the payment of dividends, redemption of its stock or the payment of other distributions on its stock; the amount of paid-in surplus, net assets, other surplus, annual or other net profit, net assets in excess of capital, undivided profits or excess of profits over losses on sales of assets; the amount, purpose, time of creation, increase or decrease, alteration or cancellation of any reserves or charges and the propriety thereof (whether or not any obligation or liability for which such reserves or charges shall have been created shall have been paid or discharged); the fair value, or any sale, bid or asked price to be applied in determining the fair value, of any asset owned or held by the Corporation; any matter relating to the acquisition, holding and disposition of any assets by the Corporation; or any other matter relating to the business and affairs of the Corporation.

Section 5.7 *REIT Qualification.* The Board of Directors shall use its reasonable best efforts to take such actions as are necessary or appropriate to preserve the status of the Corporation as a REIT; provided, however, if the Board of Directors determines that it is no longer in the best interests of the Corporation to continue to be qualified as a REIT, the Board of Directors may revoke or otherwise terminate the Corporation's REIT election pursuant to Section 856(g) of the Code. The Board of Directors also may determine that compliance with any restriction or limitation on stock ownership and transfers set forth in Article VII is no longer required for REIT qualification.

Section 5.8 *Removal of Directors.* Subject to the rights of holders of one or more classes or series of Preferred Stock (as defined herein) to elect or remove one or more directors, any director, or the entire Board of Directors, may be removed from office at any time, but only for cause and then only by the affirmative vote of at least two-thirds of the votes entitled to be cast generally in the election of directors. For the purpose of this paragraph, "cause" shall mean, with respect to any particular director, conviction of a felony or a final judgment of a court of competent jurisdiction holding that such director caused demonstrable, material harm to the Corporation through bad faith or active and deliberate dishonesty.

## ARTICLE VI

### STOCK

Section 6.1 *Authorized Shares.* The Corporation has authority to issue 120,000,000 shares of stock, consisting of 100,000,000 shares of

---

10,000,000 shares of Special Voting Stock, \$.01 par value per share (“Special Voting Stock”), and 10,000,000 shares of Preferred Stock, \$.01 par value per share (“Preferred Stock”). The aggregate par value of all authorized shares of stock having par value is \$1,200,000. If shares of one class of stock are classified or reclassified into shares of another class of stock pursuant to this Article VI, the number of authorized shares of the former class shall be automatically decreased and the number of shares of the latter class shall be automatically increased, in each case by the number of shares so classified or reclassified, so that the aggregate number of shares of stock of all classes that the Corporation has authority to issue shall not be more than the total number of shares of stock set forth in the first sentence of this paragraph. To the extent permitted by Maryland law, the Board of Directors, without any action by the stockholders of the Corporation, may amend the Charter from time to time to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class or series that the Corporation has authority to issue.

Section 6.2 *Common Stock*. Subject to the provisions of Article VII, each share of Common Stock shall entitle the holder thereof to one vote. The Board of Directors may reclassify any unissued shares of Common Stock from time to time in one or more classes or series of stock.

Section 6.3 *Special Voting Stock*.

Section 6.3.1 *Dividends and Distributions*. The holders of shares of Special Voting Stock shall not be entitled to any regular or special dividend payments. Without limiting the foregoing, the holders of shares of Special Voting Stock shall not be entitled to any dividends or other distributions declared or paid with respect to the shares of Common Stock or any other stock of the Corporation.

Section 6.3.2 *Voting Rights*. The holders of shares of Special Voting Stock shall have the following voting rights:

(a) Subject to the provisions for adjustment set forth in this Section 6.3.2, each share of Special Voting Stock shall entitle the holder thereof to one vote on all matters submitted to a vote of the stockholders of the Corporation. The holders of shares of Special Voting Stock shall vote collectively with the holders of shares of Common Stock as one class on all matters submitted to a vote of stockholders of the Corporation, and, except as expressly set forth in Section 6.3.8 hereof, the holders of shares of Special Voting Stock shall have no other voting rights, as a separate class or otherwise, including any rights to vote as a class with respect to any extraordinary corporate action such as a merger, consolidation, dissolution, liquidation or the like.

(b) In the event that the Corporation shall (i) declare or pay a dividend on its outstanding shares of Common Stock in shares of Common Stock or make a distribution to all holders of its outstanding shares of Common Stock in shares of Common Stock, (ii) split or subdivide its outstanding shares of Common Stock or (iii) effect a reverse stock split or otherwise combine its outstanding shares of Common Stock into a smaller number of shares of Common Stock, then, in each such case, the number of votes per share of Special Voting Stock to which the holders of Special Voting Stock were entitled immediately prior to the completion of any such event shall be adjusted by multiplying such number by a fraction, (x) the numerator of which shall be the number of shares of Common Stock issued and outstanding on the record date for such dividend, distribution, split, subdivision, reverse split or combination (assuming for such purposes that such dividend, distribution, split, subdivision, reverse split or combination had occurred as of such time) and (y) the denominator of which shall be the actual number of shares of Common Stock (determined without the above assumption) issued and outstanding on the record date for such dividend, distribution, split, subdivision, reverse split or combination.

---

Section 6.3.3 *Pairing*. The Corporation shall not issue or agree to issue any shares of Special Voting Stock to any person unless effective provision has been made for the simultaneous issuance by Affordable Residential Communities LP, a Delaware limited partnership (the “Operating Partnership”), to the same person of the same number of Paired Common Units (as defined in the Agreement of Limited Partnership of the Operating Partnership, as amended from time to time (the “Partnership Agreement”)), and for the pairing of such shares of Special Voting Stock and Paired Common Units in accordance with the Pairing Agreement (the “Pairing Agreement”), dated as of the date hereof, by and between the Corporation and the Operating Partnership. Until the limitation on transfer provided for in Section 1 of the Pairing Agreement shall be terminated in accordance with the terms of the Pairing Agreement:

(a) No share of Special Voting Stock shall be transferable, and no such share shall be transferred on the stock transfer books of the Corporation, except in accordance with (i) the provisions of the Pairing Agreement and (ii) the provisions of Article XI of the Partnership Agreement.

(b) A legend shall be placed on the face of each certificate representing ownership of shares of Special Voting Stock referring to the restriction on transfer set forth herein and in the Pairing Agreement.

Section 6.3.4 *Reacquired Shares*. Any shares of Special Voting Stock acquired by the Corporation or the Operating Partnership in any manner whatsoever (including any shares acquired by the Corporation or the Operating Partnership as contemplated by Section 8.6.F(8) of the Partnership Agreement) shall be cancelled automatically, shall cease to be outstanding and shall become authorized but unissued shares of Special Voting Stock, and the former holder or holders thereof shall have no further rights (hereunder or otherwise) with respect to such shares. Any shares of Special Voting Stock that are cancelled in accordance with the preceding sentence may be issued by the Corporation as shares of Special Voting Stock in accordance with the applicable provision of the charter.

Section 6.3.5 *Liquidation, Dissolution or Winding Up.* The holders of shares of Special Voting Stock shall not be entitled to any distribution rights or any other rights to receive any property upon any liquidation (voluntary or otherwise), dissolution or winding up of the Corporation.

Section 6.3.6. *Redemption.* The shares of Special Voting Stock shall not be redeemable by the Corporation. Notwithstanding the foregoing, if at any time any limited partner of the Operating Partnership elects to redeem any Paired Common Unit pursuant to Section 8.6 of the Partnership Agreement and the Corporation exercises its rights under Section 8.6.B of the Partnership Agreement to acquire any or all of such Paired Common Units in exchange for shares of Common Stock, then upon the acquisition by the Corporation of any such Paired Common Units in exchange for shares of Common Stock in accordance with the terms and conditions of the Partnership Agreement, the shares of Special Voting Stock paired with the Paired Common Units so acquired shall become authorized but unissued shares of Special Voting Stock as contemplated by Section 6.3.4 above, and thereafter the former holders thereof shall have no further rights (hereunder or otherwise) with respect to such shares.

Section 6.3.7 *Certain Business Combinations Involving the Operating Partnership.* In the event that the Operating Partnership is party to any consolidation, merger, combination or other transaction pursuant to which the Paired Common Units are converted or changed into or exchanged for stock and/or other securities of any other entity and/or cash or any other property, then in any such case the shares of Special Voting Stock paired with such Paired Common Units shall be cancelled and extinguished at and as of the effective time of such transaction without any consideration therefor (except for the consideration, if any, provided for in the agreement with

5

---

respect to such transaction), and thereafter the former holders of such shares of Special Voting Stock shall have no further rights (hereunder or otherwise) with respect to such cancelled and extinguished shares.

Section 6.3.8 *Amendment.* The Charter shall not be amended in any manner that would materially alter or change the powers, preferences or special rights of the Special Voting Stock, as set forth herein, so as to affect them adversely without the affirmative vote of the holders of at least a majority of the outstanding shares of Special Voting Stock, voting separately as a class.

Section 6.3.9 *Fractional Shares.* Special Voting Stock may be issued in fractions of a share which shall entitle the holder, in proportion to such holder's fractional shares, to exercise voting rights and to have the benefit of all other rights of holders of Special Voting Stock.

Section 6.4 *Preferred Stock.* The Board of Directors may classify any unissued shares of Preferred Stock and reclassify any previously classified but unissued shares of Preferred Stock of any series from time to time, in one or more classes or series of stock.

Section 6.5 *Classified or Reclassified Shares.* Prior to issuance of classified or reclassified shares of any class or series, the Board of Directors by resolution shall: (a) designate that class or series to distinguish it from all other classes and series of stock of the Corporation; (b) specify the number of shares to be included in the class or series; (c) set or change, subject to the provisions of Article VII and subject to the express terms of any class or series of stock of the Corporation outstanding at the time, the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms and conditions of redemption for each class or series; and (d) cause the Corporation to file articles supplementary with the State Department of Assessments and Taxation of Maryland ("SDAT"). Any of the terms of any class or series of stock set or changed pursuant to clause (c) of this Section 6.5 may be made dependent upon facts or events ascertainable outside the Charter (including determinations by the Board of Directors or other facts or events within the control of the Corporation) and may vary among holders thereof, provided that the manner in which such facts, events or variations shall operate upon the terms of such class or series of stock is clearly and expressly set forth in the articles supplementary or other Charter document filed with the SDAT.

Section 6.6 *Charter and Bylaws.* All persons who shall acquire stock in the Corporation shall acquire the same subject to the provisions of the Charter and the Bylaws.

## ARTICLE VII

### RESTRICTION ON TRANSFER AND OWNERSHIP OF SHARES

Section 7.1 *Definitions.* For the purpose of this Article VII, the following terms shall have the following meanings:

*Aggregate Stock Ownership Limit.* The term "Aggregate Stock Ownership Limit" shall mean not more than 9.8% in value of the aggregate of the outstanding shares of Stock. The value of the outstanding shares of Stock shall be determined by the Board of Directors of the Corporation in good faith, which determination shall be conclusive for all purposes hereof.

*Beneficial Ownership.* The term "Beneficial Ownership" shall mean ownership of Stock by a Person, whether the interest in the shares of Stock is held directly or indirectly (including by a nominee), and shall include interests that would be treated as owned through the application of Section 544 of the Code, as modified by Section 856(h)(1)(B) of the Code. The terms "Beneficial Owner," "Beneficially Owns" and "Beneficially Owned" shall have the correlative meanings.

6

---

*Business Day.* The term “Business Day” shall mean any day, other than a Saturday or Sunday, that is neither a legal holiday nor a day on which banking institutions in New York City are authorized or required by law, regulation or executive order to close.

*Charitable Beneficiary.* The term “Charitable Beneficiary” shall mean one or more beneficiaries of the Trust as determined pursuant to Section 7.3.6, provided that each such organization must be described in Section 501(c)(3) of the Code and contributions to each such organization must be eligible for deduction under each of Sections 170(b)(1)(A), 2055 and 2522 of the Code.

*Common Stock Ownership Limit.* The term “Common Stock Ownership Limit” shall mean 9.8% (in value or in number of shares, whichever is more restrictive) of the aggregate of the outstanding shares of Common Stock of the Corporation. The number and value of outstanding shares of Common Stock of the Corporation shall be determined by the Board of Directors of the Corporation in good faith, which determination shall be conclusive for all purposes hereof.

*Constructive Ownership.* The term “Constructive Ownership” shall mean ownership of Stock by a Person, whether the interest in the shares of Stock is held directly or indirectly (including by a nominee), and shall include interests that would be treated as owned through the application of Section 318(a) of the Code, as modified by Section 856(d)(5) of the Code. The terms “Constructive Owner,” “Constructively Owns” and “Constructively Owned” shall have the correlative meanings.

*Excepted Holder.* The term “Excepted Holder” shall mean any stockholder of the Corporation for whom an Excepted Holder Limit is created by the Charter or by the Board of Directors pursuant to Section 7.2.7.

*Excepted Holder Limit.* The term “Excepted Holder Limit” shall mean, as it relates to any Excepted Holder, provided that the affected Excepted Holder agrees to comply with the requirements established by the Board of Directors pursuant to Section 7.2.7, and subject to adjustment pursuant to Section 7.2.8, the percentage limit established by the Board of Directors pursuant to Section 7.2.7.

*Individual.* The term “Individual” shall mean any person that is treated as an individual for purposes of Section 542(a)(2) of the Code, as modified by Section 856(h)(3) of the Code.

*Initial Date.* The term “Initial Date” shall mean the date upon which the Articles of Amendment and Restatement containing this Article VII are filed with the SDAT.

*Market Price.* The term “Market Price” on any date shall mean, with respect to any class or series of outstanding shares of Stock, the Closing Price for such Stock on such date. The “Closing Price” on any date shall mean the last sale price for such Stock, regular way, or, in case no such sale takes place on such day, the average of the closing bid and asked prices, regular way, for such Stock, in either case as reported in the principal consolidated transaction reporting system with respect to securities listed or admitted to trading on the NYSE or, if such Stock is not listed or admitted to trading on the NYSE, as reported on the principal consolidated transaction reporting system with respect to securities listed on the principal national securities exchange on which such Stock is listed or admitted to trading or, if such Stock is not listed or admitted to trading on any national securities exchange, the last quoted price, or, if not so quoted, the average of the high bid and low asked prices in the over-the-counter market, as reported by the National Association of Securities Dealers, Inc. Automated Quotation System or, if such system is no longer in use, the principal other automated quotation system that may then be in use or, if such Stock is not quoted by any such organization, the average of the closing bid and asked prices as furnished by a professional market maker making a market in such Stock selected by the Board of Directors of

---

the Corporation or, in the event that no trading price is available for such Stock, the fair market value of the Stock, as determined in good faith by the Board of Directors of the Corporation.

*Non-U.S. Person.* The term “Non-U.S. Person” shall mean a Person other than a U.S. Person.

*NYSE.* The term “NYSE” shall mean the New York Stock Exchange.

*Person.* The term “Person” shall mean an Individual, corporation, partnership, limited liability company, estate, trust (including a trust qualified under Sections 401(a) or 501(c)(17) of the Code), a portion of a trust permanently set aside for or to be used exclusively for the purposes described in Section 642(c) of the Code, association, private foundation within the meaning of Section 509(a) of the Code, joint stock company or other entity and also includes a group as that term is used for purposes of Section 13(d)(3) of the Securities Exchange Act of 1934, as amended, and a group to which an Excepted Holder Limit applies.

*Prohibited Owner.* The term “Prohibited Owner” shall mean, with respect to any purported Transfer, any Person who, but for the provisions of Section 7.2, would Beneficially Own or Constructively Own shares of Stock, and if appropriate in the context, shall also mean any Person who would have been the record owner of the shares that the Prohibited Owner would have so owned.

*Restriction Termination Date.* The term “Restriction Termination Date” shall mean the first day after the Initial Date on which the Corporation determines pursuant to Section 5.7 of the Charter that it is no longer in the best interests of the Corporation to attempt to, or continue to, qualify as a REIT or that compliance with the restrictions and limitations on Beneficial Ownership, Constructive Ownership and Transfers of shares of Stock set forth herein is no longer required in order for the Corporation to qualify as a REIT.

*Stock.* The term “Stock” shall mean all classes or series of stock of the Corporation, including, without limitation, Common Stock, Special Voting Stock and Preferred Stock.



*Transfer.* The term “Transfer” shall mean any issuance, sale, transfer, gift, assignment, devise or other disposition, as well as any other event that causes any Person to acquire Beneficial Ownership or Constructive Ownership, or any agreement to take any such actions or cause any such events, of Stock or the right to vote or receive dividends on Stock, including (a) the granting or exercise of any option (or any disposition of any option), (b) any disposition of any securities or rights convertible into or exchangeable for Stock or any interest in Stock or any exercise of any such conversion or exchange right and (c) Transfers of interests in other entities that result in changes in Beneficial or Constructive Ownership of Stock; in each case, whether voluntary or involuntary, whether owned of record, Constructively Owned or Beneficially Owned and whether by operation of law or otherwise. The terms “Transferring” and “Transferred” shall have the correlative meanings.

*Trust.* The term “Trust” shall mean any trust provided for in Section 7.3.1.

*Trustee.* The term “Trustee” shall mean the Person unaffiliated with the Corporation and a Prohibited Owner, that is appointed by the Corporation to serve as trustee of the Trust.

*U.S. Person.* The term “U.S. Person” shall mean (a) a citizen or resident of the United States, (b) a partnership or corporation formed or organized under the laws of the United States or any state therein (including the District of Columbia), (c) any estate or trust (other than a foreign estate or foreign trust within the meaning of Section 7701(a)(31) of the Code) or (d) any other Person that is a U.S. person for federal income tax purposes.

## Section 7.2 *Stock.*

Section 7.2.1 *Ownership Limitations.* Subject to Section 7.4 and except as provided in Section 7.2.7, during the period commencing on the Initial Date and continuing until the Restriction Termination Date:

(a) *Basic Restrictions.*

(i) (1) No Individual, other than an Excepted Holder, shall Beneficially Own or Constructively Own shares of Stock in excess of the Aggregate Stock Ownership Limit, (2) no Individual, other than an Excepted Holder, shall Beneficially Own or Constructively Own shares of Common Stock in excess of the Common Stock Ownership Limit and (3) no Excepted Holder shall Beneficially Own or Constructively Own shares of Stock in excess of the Excepted Holder Limit for such Excepted Holder.

(ii) No Person shall Beneficially Own shares of Stock to the extent that such Beneficial Ownership of Stock would result in the Corporation being “closely held” within the meaning of Section 856(h) of the Code (without regard to whether the ownership interest is held during the last half of a taxable year), or otherwise failing to qualify as a REIT (including, but not limited to, Beneficial Ownership that would result in the Corporation owning (actually or Constructively) an interest in a tenant that is described in Section 856(d)(2)(B) of the Code if the income derived by the Corporation (either directly or indirectly through one or more partnerships or limited liability companies) from such tenant would cause the Corporation to fail to satisfy any of the gross income requirements of Section 856(c) of the Code).

(iii) Subject to Section 7.4, notwithstanding any other provisions contained herein, any Transfer of shares of Stock or other event that, if effective, would result in the Stock being beneficially owned by less than 100 Persons (determined under the principles of Section 856(a)(5) of the Code (but without reference to the rules of attribution under Section 544 of the Code)) shall be void *ab initio*, and the intended transferee shall acquire no rights in such shares of Stock.

(iv) No Person shall Beneficially Own or Constructively Own shares of Stock to the extent that such Beneficial Ownership or Constructive Ownership of Stock would result in Non-U.S. Persons directly or indirectly owning shares of Stock the fair market value of which would comprise 50% or more of the fair market value of the issued and outstanding shares of Stock.

(b) *Transfer in Trust.* If any Transfer of shares of Stock or other event occurs which, if effective, would result in any Person Beneficially Owning or Constructively Owning, in violation of Section 7.2.1(a)(i), or Beneficially Owning, in violation of Section 7.2.1(a)(ii), or directly or indirectly owning, in violation of Section 7.2.1(a)(iv), shares of Stock,

(i) then that number of shares of Stock the Beneficial or Constructive Ownership, or direct or indirect ownership, of which otherwise would cause such Person to violate Section 7.2.1(a)(i), (ii) or (iv) (rounded to the nearest whole share) shall be automatically

transferred to a Trust for the benefit of a Charitable Beneficiary, as described in Section 7.3, effective as of the close of business on the Business Day prior to the date of such Transfer or other event, and such Person shall acquire no rights in such shares; or

(ii) if the transfer to the Trust described in clause (i) of this Section 7.2.1(b) would not be effective for any reason to prevent the violation of Section 7.2.1(a)(i), (ii) or (iv), then the Transfer of that number of shares of Stock that otherwise would cause any Person to violate Section 7.2.1(a)(i), (ii) or (iv) shall be void *ab initio*, and the intended transferee shall acquire no rights in such shares of Stock.

Section 7.2.2 *Remedies for Breach.* If the Board of Directors of the Corporation or any duly authorized committee thereof shall at any time determine in good faith that a Transfer or other event has taken place that results in a violation of Section 7.2.1 or that a Person intends to acquire or has attempted to acquire Beneficial or Constructive Ownership of any shares of Stock in violation of Section 7.2.1 (whether or not such violation is intended), the Board of Directors or a committee thereof shall take such action as it deems advisable to refuse to give effect to or to prevent such Transfer or other event, including, without limitation, causing the Corporation to redeem shares, refusing to give effect to such Transfer or other event on the books of the Corporation or instituting proceedings to enjoin such Transfer or other event; *provided, however*, that any Transfer or attempted Transfer or other event in violation of Section 7.2.1 shall automatically result in the transfer to the Trust described above, and, where applicable, such Transfer (or other event) shall be void *ab initio* as provided above irrespective of any action (or non-action) by the Board of Directors or a committee thereof.

Section 7.2.3 *Notice of Restricted Transfer.* Any Person who acquires or attempts or intends to acquire Beneficial Ownership or Constructive Ownership of shares of Stock that will or may violate Section 7.2.1(a) or any Person who would have owned shares of Stock that resulted in a transfer to the Trust pursuant to the provisions of Section 7.2.1(b) shall immediately give written notice to the Corporation of such event, or in the case of such a proposed or attempted transaction, give at least 15 days prior written notice, and shall provide to the Corporation such other information as the Corporation may request in order to determine the effect, if any, of such Transfer on the Corporation's status as a REIT.

Section 7.2.4 *Owners Required To Provide Information.* From the Initial Date and prior to the Restriction Termination Date:

(a) every owner of more than five percent (or such lower percentage as required by the Code or the Treasury Regulations promulgated thereunder) of the outstanding shares of Stock, within 30 days after the end of each taxable year, shall give written notice to the Corporation stating the name and address of such owner, the number of shares of Stock Beneficially Owned and a description of the manner in which such shares are held. Each such owner shall provide to the Corporation such additional information as the Corporation may request in order to determine the effect, if any, of such Beneficial Ownership on the Corporation's status as a REIT and to ensure compliance with the Aggregate Stock Ownership Limit; and

(b) each Person who is a Beneficial or Constructive Owner of Stock and each Person (including the stockholder of record) who is holding Stock for a Beneficial or Constructive Owner shall provide to the Corporation such information as the Corporation may request, in good faith, in order to determine the Corporation's status as a REIT and to comply with requirements of any taxing authority or governmental authority or to determine such compliance.

10

---

Section 7.2.5 *Remedies Not Limited.* Subject to Section 5.7 of the Charter, nothing contained in this Article VII shall limit the authority of the Board of Directors of the Corporation to take such other action as it deems necessary or advisable to protect the Corporation and the interests of its stockholders in preserving the Corporation's status as a REIT.

Section 7.2.6 *Ambiguity.* In the case of an ambiguity in the application of any of the provisions of this Article VII, the Board of Directors of the Corporation shall have the power to determine the application of the provisions of this Article VII with respect to any situation based on the facts known to it. In the event Section 7.2 or 7.3 requires an action by the Board of Directors and the Charter fails to provide specific guidance with respect to such action, the Board of Directors shall have the power to determine the action to be taken so long as such action is not contrary to the provisions of Sections 7.1, 7.2 or 7.3. Absent a decision to the contrary by the Board of Directors (which the Board may make in its sole and absolute discretion), if a Person would have (but for the remedies set forth in Section 7.2.2) acquired Beneficial or Constructive Ownership, or direct or indirect ownership, of Stock in violation of Section 7.2.1, such remedies (as applicable) shall apply first to the shares of Stock which, but for such remedies, would have been Beneficially Owned or Constructively Owned (but not actually owned) by such Person, pro rata among the Persons who actually own such shares of Stock based upon the relative number of the shares of Stock held by each such Person.

Section 7.2.7 *Exceptions.*

(a) Subject to Section 7.2.1(a)(ii), (iii) and (iv), the Board of Directors of the Corporation, in its sole discretion, may exempt (prospectively or retroactively) an Individual from the Aggregate Stock Ownership Limit and the Common Stock Ownership Limit, as the case may be, and may establish or increase an Excepted Holder Limit for such Individual if:

(i) the Board of Directors obtains such representations and undertakings from such Individual as are reasonably necessary to ascertain that no Person's Beneficial or Constructive Ownership of such shares of Stock will violate Section 7.2.1(a)(ii), (iii) or (iv) and that any such exception will not cause the Corporation to fail to qualify as a REIT under the Code;

(ii) such Individual does not and represents that he or she will not own, actually or Constructively, an interest in a tenant of the Corporation (or a tenant of any entity owned or controlled by the Corporation) that would cause the Corporation to own, actually or Constructively, more than a 9.9% interest (as set forth in Section 856(d)(2) (B) of the Code) in such tenant and the Board of Directors obtains such representations and undertakings from such

Individual as are reasonably necessary to ascertain this fact (for this purpose, a tenant from whom the Corporation (or an entity owned or controlled by the Corporation) derives (and is expected to continue to derive) a sufficiently small amount of revenue such that, in the opinion of the Board of Directors of the Corporation, rent from such tenant would not adversely affect the Corporation's ability to qualify as a REIT, shall not be treated as a tenant of the Corporation); and

(iii) such Individual agrees that any violation or attempted violation of such representations or undertakings (or other action which is contrary to the restrictions contained in Sections 7.2.1 through 7.2.6) will result in such shares of Stock being automatically transferred to a Trust in accordance with Sections 7.2.1(b) and 7.3. If the Board of Directors of the Corporation establishes or increases an Excepted Holder Limit for one or more Individuals under this Section, it may reasonably determine that a correlative downward adjustment to the Aggregate Stock Ownership Limit and/or Common Stock Ownership Limit should be made.

11

---

(b) Prior to granting any exception pursuant to Section 7.2.7(a), the Board of Directors of the Corporation may require a ruling from the Internal Revenue Service, or an opinion of counsel, in either case in form and substance satisfactory to the Board of Directors in its sole discretion, as it may deem necessary or advisable in order to determine or ensure the Corporation's status as a REIT. Notwithstanding the receipt of any ruling or opinion, the Board of Directors may impose such conditions or restrictions as it deems appropriate in connection with granting such exception.

(c) The Board of Directors may only reduce the Excepted Holder Limit for an Excepted Holder: (1) with the written consent of such Excepted Holder at any time, or (2) pursuant to the terms and conditions of the agreements and undertakings entered into with such Excepted Holder in connection with the establishment of the Excepted Holder Limit for that Excepted Holder. No Excepted Holder Limit shall be reduced to a percentage that is less than the Common Stock Ownership Limit.

Section 7.2.8 *Increase in Aggregate Stock Ownership and Common Stock Ownership Limits.* Subject to Section 7.2.1(a)(ii), (iii) and (iv), the Board of Directors may from time to time increase the Common Stock Ownership Limit and the Aggregate Stock Ownership Limit for one or more Individuals and decrease the Common Stock Ownership Limit and the Aggregate Stock Ownership Limit for all other Individuals; provided, however, that the decreased Common Stock Ownership Limit and/or Aggregate Stock Ownership Limit will not be effective for any Individual whose percentage ownership in Stock is in excess of such decreased Common Stock Ownership Limit and/or Aggregate Stock Ownership Limit until such time as such Individual's percentage of Stock equals or falls below the decreased Common Stock Ownership Limit and/or Aggregate Stock Ownership Limit, but any further acquisition of Stock in excess of such percentage ownership of Stock will be in violation of the Common Stock Ownership Limit and/or Aggregate Stock Ownership Limit and, provided further, that the new Common Stock Ownership Limit and/or Aggregate Stock Ownership Limit would not allow five or fewer Individuals to Beneficially Own more than 49.9% in value of the outstanding Stock.

Section 7.2.9 *Legend.* Each certificate for shares of Stock shall bear substantially the following legend:

The shares represented by this certificate are subject to restrictions on Beneficial and Constructive Ownership and Transfer for the purpose of the Corporation's maintenance of its status as a Real Estate Investment Trust under the Internal Revenue Code of 1986, as amended (the "Code"). Subject to certain further restrictions and except as expressly provided in the Corporation's Charter, (i) no Individual may Beneficially or Constructively Own shares of the Corporation's Common Stock in excess of 9.8% (in value or number of shares, whichever is more restrictive) of the outstanding shares of Common Stock of the Corporation unless such Individual is an Excepted Holder (in which case the Excepted Holder Limit shall be applicable); (ii) no Individual may Beneficially or Constructively Own shares of Stock of the Corporation in excess of 9.8% of the value of the total outstanding shares of Stock of the Corporation, unless such Individual is an Excepted Holder (in which case the Excepted Holder Limit shall be applicable); (iii) no Person may Beneficially Own Stock that would result in the Corporation being "closely held" under Section 856(h) of the Code or otherwise cause the Corporation to fail to qualify as a REIT; (iv) no Person shall Beneficially Own or Constructively Own shares of Stock to the extent that such Beneficial Ownership or Constructive Ownership of Stock would result in Non-U.S. Persons directly or indirectly owning shares of Stock the fair market value of which would comprise 50% or more of the fair market value of the issued and outstanding shares of Stock; and (v) no Person may Transfer shares of Stock if such Transfer would result in the Stock of the

12

---

Corporation being beneficially owned by fewer than 100 Persons. Any Person who Beneficially or Constructively Owns, or directly or indirectly owns, or attempts to Beneficially or Constructively Own, or directly or indirectly own, shares of Stock which causes or will cause a Person to Beneficially or Constructively Own, or directly or indirectly own, shares of Stock in excess or in violation of the above limitations must immediately notify the Corporation. If any of the restrictions on transfer or ownership (excluding (v) above) are violated, the shares of Stock represented hereby will be automatically transferred to a Trustee of a Trust for the benefit of one or more Charitable Beneficiaries. In addition, the Corporation may redeem shares upon the terms and conditions specified by the Board of Directors in its sole discretion if the Board of Directors determines that ownership or a Transfer or other event may violate the restrictions described above. Furthermore, upon the occurrence of certain events, attempted Transfers in violation of the restrictions described above may be void *ab initio*. All capitalized terms in this legend have the meanings defined in the charter of the Corporation, as

the same may be amended from time to time, a copy of which, including the restrictions on transfer and ownership, will be furnished to each holder of Stock of the Corporation on request and without charge. Requests for such a copy may be directed to the Secretary of the Corporation at its Principal Office.

Instead of the foregoing legend, the certificate may state that the Corporation will furnish a full statement about certain restrictions on transferability to a stockholder on request and without charge.

### Section 7.3 *Transfer of Stock in Trust.*

Section 7.3.1 *Ownership in Trust.* Upon any purported Transfer or other event described in Section 7.2.1(b) that would result in a transfer of shares of Stock to a Trust, such shares of Stock shall be deemed to have been transferred to the Trustee as trustee of a Trust for the exclusive benefit of one or more Charitable Beneficiaries. Such transfer to the Trustee shall be deemed to be effective as of the close of business on the Business Day prior to the purported Transfer or other event that results in the transfer to the Trust pursuant to Section 7.2.1(b). The Trustee shall be appointed by the Corporation and shall be a Person unaffiliated with the Corporation and any Prohibited Owner. Each Charitable Beneficiary shall be designated by the Corporation as provided in Section 7.3.6.

Section 7.3.2 *Status of Shares Held by the Trustee.* Shares of Stock held by the Trustee shall be issued and outstanding shares of Stock of the Corporation. The Prohibited Owner shall have no rights in the shares held by the Trustee. The Prohibited Owner shall not benefit economically from ownership of any shares held in trust by the Trustee, shall have no rights to dividends or other distributions and shall not possess any rights to vote or other rights attributable to the shares held in the Trust.

Section 7.3.3 *Dividend and Voting Rights.* The Trustee shall have all voting rights and rights to dividends or other distributions with respect to shares of Stock held in the Trust, which rights shall be exercised for the exclusive benefit of the Charitable Beneficiary. Any dividend or other distribution paid prior to the discovery by the Corporation that the shares of Stock have been transferred to the Trustee shall be paid by the recipient of such dividend or distribution to the Trustee upon demand and any dividend or other distribution authorized but unpaid shall be paid when due to the Trustee. Any dividend or distribution so paid to the Trustee shall be held in trust for the Charitable Beneficiary. The Prohibited Owner shall have no voting rights with respect to shares held in the Trust and, subject to Maryland law, effective as of the date that the shares of Stock have been transferred to the Trustee, the Trustee shall have the authority (at the Trustee's sole discretion) (i) to rescind as void any vote cast by a Prohibited Owner prior to the discovery by the Corporation that the shares of Stock have been transferred to the Trustee and (ii) to recast

such vote in accordance with the desires of the Trustee acting for the benefit of the Charitable Beneficiary; provided, however, that if the Corporation has already taken irreversible corporate action, then the Trustee shall not have the authority to rescind and recast such vote. Notwithstanding the provisions of this Article VII, until the Corporation has received notification that shares of Stock have been transferred into a Trust, the Corporation shall be entitled to rely on its share transfer and other stockholder records for purposes of preparing lists of stockholders entitled to vote at meetings, determining the validity and authority of proxies and otherwise conducting votes of stockholders.

Section 7.3.4 *Sale of Shares by Trustee.* Within 20 days of receiving notice from the Corporation that shares of Stock have been transferred to the Trust, the Trustee of the Trust shall sell the shares held in the Trust to a person, designated by the Trustee, whose ownership of the shares will not violate the ownership limitations set forth in Section 7.2.1(a). Upon such sale, the interest of the Charitable Beneficiary in the shares sold shall terminate and the Trustee shall distribute the net proceeds of the sale to the Prohibited Owner and to the Charitable Beneficiary as provided in this Section 7.3.4. The Prohibited Owner shall receive the lesser of (1) the price paid by the Prohibited Owner for the shares or, if the Prohibited Owner did not give value for the shares in connection with the event causing the shares to be held in the Trust (e.g., in the case of a gift, devise or other such transaction), the Market Price of the shares on the day of the event causing the shares to be held in the Trust and (2) the price per share received by the Trustee (net of any commissions and other expenses of sale) from the sale or other disposition of the shares held in the Trust. The Trustee may reduce the amount payable to the Prohibited Owner by the amount of dividends and distributions which have been paid to the Prohibited Owner and are owed by the Prohibited Owner to the Trustee pursuant to Section 7.3.3 of this Article VII. Any net sales proceeds in excess of the amount payable to the Prohibited Owner shall be immediately paid to the Charitable Beneficiary. If, prior to the discovery by the Corporation that shares of Stock have been transferred to the Trustee, such shares are sold by a Prohibited Owner, then (i) such shares shall be deemed to have been sold on behalf of the Trust and (ii) to the extent that the Prohibited Owner received an amount for such shares that exceeds the amount that such Prohibited Owner was entitled to receive pursuant to this Section 7.3.4, such excess shall be paid to the Trustee upon demand.

Section 7.3.5 *Purchase Right in Stock Transferred to the Trustee.* Shares of Stock transferred to the Trustee shall be deemed to have been offered for sale to the Corporation, or its designee, at a price per share equal to the lesser of (i) the price per share in the transaction that resulted in such transfer to the Trust (or, in the case of a devise or gift, the Market Price at the time of such devise or gift) and (ii) the Market Price on the date the Corporation, or its designee, accepts such offer. The Corporation may reduce the amount payable to the Prohibited Owner by the amount of dividends and distributions which have been paid to the Prohibited Owner and are owed by the Prohibited Owner to the Trustee pursuant to Section 7.3.3 of this Article VII. The Corporation may pay the amount of such reductions to the Trustee for the benefit of the Charitable Beneficiary. The Corporation shall have the right to accept such offer until the Trustee has sold the shares held in the Trust pursuant to Section 7.3.4. Upon such a sale to the Corporation, the interest of the Charitable Beneficiary in the shares sold shall terminate and the Trustee shall distribute the net proceeds of the sale to the Prohibited Owner.

Section 7.3.6 *Designation of Charitable Beneficiaries.* By written notice to the Trustee, the Corporation shall designate one or more nonprofit organizations to be the Charitable Beneficiary of the interest in the Trust such that (i) the shares of Stock held in the Trust would not violate the restrictions set forth in Section 7.2.1(a) in the hands of such Charitable Beneficiary and (ii) each such organization

such organization must be eligible for deduction under each of Sections 170(b)(1)(A), 2055 and 2522 of the Code.

**Section 7.4 NYSE Transactions.** Nothing in this Article VII shall preclude the settlement of any transaction entered into through the facilities of the NYSE or any other national securities exchange or automated inter-dealer quotation system. The fact that the settlement of any transaction occurs shall not negate the effect of any other provision of this Article VII and any transferee in such a transaction shall be subject to all of the provisions and limitations set forth in this Article VII.

**Section 7.5 Enforcement.** The Corporation is authorized specifically to seek equitable relief, including injunctive relief, to enforce the provisions of this Article VII.

**Section 7.6 Non-Waiver.** No delay or failure on the part of the Corporation or the Board of Directors in exercising any right hereunder shall operate as a waiver of any right of the Corporation or the Board of Directors, as the case may be, except to the extent specifically waived in writing.

**Section 7.7 Severability.** If any provision of this Article VII or any application of any such provision is determined to be void, invalid or unenforceable by virtue of any legal decision, statute, rule or regulation, then a Prohibited Owner may be deemed, at the option of the Corporation, to have acted as an agent of the Corporation in acquiring such shares of Stock that resulted in such Prohibited Owner Beneficially Owning or Constructively Owning, or directly or indirectly owning, shares of Stock in violation of Section 7.2.1(a)(i), (ii) or (iv) and to hold such shares of Stock on behalf of the Corporation and the validity and enforceability of the remaining provisions shall not be affected and other applications of such provision shall be affected only to the extent necessary to comply with the determination of such court.

## **ARTICLE VIII**

### **AMENDMENTS**

The Corporation reserves the right from time to time to make any amendment to the Charter, now or hereafter authorized by law, including any amendment altering the terms or contract rights, as expressly set forth in the Charter, of any shares of outstanding stock. All rights and powers conferred by the Charter on stockholders, directors and officers are granted subject to this reservation. Any amendment to Section 5.8 or to this sentence of the charter shall be valid only if approved by the affirmative vote of two-thirds of all the votes entitled to be cast on the matter.

## **ARTICLE IX**

### **LIMITATION OF LIABILITY**

To the maximum extent that Maryland law in effect from time to time permits limitation of the liability of directors and officers of a corporation, no present or former director or officer of the Corporation shall be liable to the Corporation or its stockholders for money damages. Neither the amendment nor repeal of this Article IX, nor the adoption or amendment of any other provision of the charter or Bylaws inconsistent with this Article IX, shall apply to or affect in any respect the applicability of the preceding sentence with respect to any act or failure to act which occurred prior to such amendment, repeal or adoption.

**THIRD:** The amendment to and restatement of the charter as hereinabove set forth have been duly advised by the Board of Directors and approved by the stockholders of the Corporation as required by law.

**FOURTH:** The current address of the principal office of the Corporation is as set forth in Article IV of the foregoing amendment and restatement of the charter.

**FIFTH:** The name and address of the Corporation's current resident agent is as set forth in Article IV of the foregoing amendment and restatement of the charter.

**SIXTH:** The number of directors of the Corporation and the names of those currently in office are as set forth in Article V of the foregoing amendment and restatement of the charter.

**SEVENTH:** The total number of shares of stock which the Corporation had authority to issue immediately prior to this amendment and restatement was 110,000,000, consisting of 90,000,000 shares of Common Stock, \$.01 par value per share, 10,000,000 shares of Special Voting Stock, \$.01 par value per share, and 10,000,000 shares of Preferred Stock, \$.01 par value per share. The aggregate par value of all shares of stock having par value was \$1,100,000.

**EIGHTH:** The total number of shares of stock which the Corporation has authority to issue pursuant to the foregoing amendment and restatement of the charter is 120,000,000, consisting of 100,000,000 shares of Common Stock, \$.01 par value per share, 10,000,000 shares of Special Voting Stock, \$.01 par value per share, and 10,000,000 shares of Preferred Stock, \$.01 par value per share. The aggregate par value of all authorized shares of stock having par value is \$1,200,000.



*NINTH*: The undersigned President acknowledges these Articles of Amendment and Restatement to be the corporate act of the Corporation and as to all matters or facts required to be verified under oath, the undersigned President acknowledges that, to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties for perjury.

[signatures on next page]

16

---

IN WITNESS WHEREOF, the Corporation has caused these Articles of Amendment and Restatement to be signed in its name and on its behalf by its President and attested to by its Secretary on this 16<sup>th</sup> day of February, 2004.

**ATTEST:**

**AFFORDABLE RESIDENTIAL COMMUNITIES INC.**

By: /s/ SCOTT L. GESELL  
Name: Scott L. Gesell  
Title: Secretary

By: /s/ GEORGE MCGEENEY (SEAL)  
Name: George McGeeney  
Title: President

17

---

**AFFORDABLE RESIDENTIAL COMMUNITIES INC.**  
**Articles Supplementary**  
**Series A Cumulative Redeemable**  
**Preferred Stock**

Affordable Residential Communities Inc., a Maryland corporation (the "Corporation"), hereby certifies to the State Department of Assessments and Taxation of Maryland that:

*FIRST*: Under a power contained in Article VI of the Charter of the Corporation (the "Charter"), the Board of Directors by duly adopted resolutions classified and designated 5,750,000 shares of authorized but unissued Preferred Stock (as defined in the Charter) as shares of 8.25% Series A Cumulative Redeemable Preferred Stock, with the following preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends and other distributions, qualifications, and terms and conditions of redemption, which, upon any restatement of the Charter, shall become part of Article VI of the Charter, with any necessary or appropriate renumbering or relettering of the sections or subsections hereof.

**Series A Cumulative Redeemable Preferred Stock**

- (1) *Designation and Number.* A series of Preferred Stock, designated the "8.25% Series A Cumulative Redeemable Preferred Stock" (the "Series A Preferred Stock"), is hereby established. The number of shares of the Series A Preferred Stock shall be 5,750,000.
- (2) *Rank.* The Series A Preferred Stock shall, with respect to rights to the payment of dividends and the distribution of assets upon the liquidation, dissolution or winding up of the Corporation, rank (a) senior to all classes or series of Common Stock (as defined in the Charter) and any other class or series of stock of the Corporation if the holders of the Series A Preferred Stock are entitled to receive dividends or amounts distributable upon the liquidation, dissolution or winding up of the Corporation in preference or priority to the holders of shares of such class or series (the "Junior Stock"); (b) on a parity with any class or series of stock of the Corporation if the holders of such class or series of stock and the Series A Preferred Stock are entitled to receive dividends and amounts distributable upon the liquidation, dissolution or winding up of the Corporation in proportion to their respective amounts of accumulated, accrued and unpaid dividends per share or liquidation preferences, without preference or priority of one over the other (the "Parity Stock"); and (c) junior to any class or series of stock of the Corporation if the holders of such class or series are entitled to receive dividends and amounts distributable upon the liquidation, dissolution or winding up of the Corporation in preference or priority to the holders of the Series A Preferred Stock (the "Senior Stock").
- (3) *Dividends.*
  - (a) Subject to the preferential rights of holders of any class or series of Senior Stock, holders of the Series A Preferred Stock shall be entitled to receive, when and as authorized by the Board of Directors and declared by the Corporation, out of funds legally available for the payment of dividends, cash dividends at the rate of 8.25% per annum of the \$25.00 liquidation preference (equivalent to a fixed annual rate of \$2.0625 per share). Such dividends shall be cumulative from the first date on which any Series A Preferred Stock is issued (the "Original Issue Date") and shall be payable quarterly in arrears on or before the 30<sup>th</sup> day of each April, July, October and January of each year or, if not a business day, the next succeeding business day (each, a "Dividend Payment Date"). Any dividend payable on the Series A Preferred Stock for any partial dividend period shall be computed ratably on the basis of a 360-day year consisting of twelve 30-day months. Dividends shall be payable in arrears to holders of record as they appear in the stock records of the Corporation at the close of business on the applicable record date (the "Dividend Record Date") not less than 15 nor more than 45 days preceding the applicable Dividend Payment Date. The term "business day" shall mean any day, other than Saturday, Sunday, or a day on which banking institutions in the State of New York are authorized or obligated by law to close, or a day which is or is declared a national or a New York state holiday.

---

(b) Holders of the Series A Preferred Stock shall not be entitled to any dividends in excess of cumulative dividends, as herein provided, on the Series A Preferred Stock.

(c) No interest, or sum of money in lieu of interest, shall be payable in respect of any dividend payment or payments on the Series A Preferred Stock that may be in arrears.

(d) Holders of shares of the Series A Preferred Stock issued after February 18, 2004 shall become entitled to receive dividends payable with respect to any record date subsequent to the date of issuance of such shares.

(e) When dividends are not paid in full upon the Series A Preferred Stock or any other class or series of Parity Stock, or a sum sufficient for such payment is not set apart, all dividends declared upon the Series A Preferred Stock and any shares of Parity Stock shall be declared ratably in proportion to the respective amounts of dividends accumulated, accrued and unpaid on the Series A Preferred Stock and accumulated, accrued and unpaid on such Parity Stock (which shall not include any accumulation in respect of unpaid dividends for prior dividend periods if such Parity Stock does not have a cumulative dividend). Except as set forth in the preceding sentence, unless full cumulative dividends on the Series A Preferred Stock have been or contemporaneously are authorized, declared and paid or declared and a sum sufficient for the payment thereof is set apart for such payment for all past dividend periods and the then current dividend period, no dividends may be authorized, declared or paid or set apart for payment by the Corporation and no other distribution of cash or other property may be declared or made, directly or indirectly, by the Corporation with respect to any shares of Parity Stock.

(f) Unless full cumulative dividends equal to the full amount of all accumulated, accrued and unpaid dividends on the Series A Preferred Stock have been declared and paid, or declared and a sum sufficient for the payment thereof has been set apart for such payment, for all past dividend periods and the then current dividend period, no dividends (other than dividends or distributions paid in shares of Junior Stock or options, warrants or rights to subscribe for or purchase shares of Junior Stock) shall be authorized, declared or paid or set apart for payment by the Corporation and no other distribution of cash or other property may be authorized, declared or made, directly or indirectly, by the Corporation with respect to any shares of Junior Stock, nor shall any shares of Junior Stock be redeemed, purchased or otherwise acquired (other than a redemption, purchase or other acquisition of Common Stock made for purposes of an employee incentive or benefit plan of the Corporation) for any consideration (or any monies be paid to or made available for a sinking fund for the redemption of any shares of any such stock), directly or indirectly, by the Corporation (except by conversion into or exchange for shares of Junior Stock, or options, warrants or rights to subscribe for or purchase shares of Junior Stock), nor shall any other cash or other property be paid or distributed to or for the benefit of holders of shares of Junior Stock.

(g) Notwithstanding the foregoing provisions of this Section 3, the Corporation shall not be prohibited from (i) declaring or paying or setting apart for payment any dividend or distribution on any shares of Parity Stock or (ii) redeeming, purchasing or otherwise acquiring any Parity Stock, in each case, if such declaration, payment, redemption, purchase or other acquisition is necessary in order to maintain the continued qualification of the Corporation as a qualified real estate investment trust ("REIT") under Section 856 of the Code (as defined in the Charter).

(4) *Liquidation Preference.*

(a) Upon any voluntary or involuntary liquidation, dissolution or winding up of the Corporation, before any payment or distribution by the Corporation shall be made to or set apart for the holders of any shares of Junior Stock, the holders of shares of the Series A Preferred Stock shall be entitled to be paid out of the assets of the Corporation that are legally available for distribution to the stockholders, a liquidation preference of \$25.00 per share (the "Liquidation Preference"), plus an amount equal to all accumulated, accrued and unpaid dividends (whether or

not earned or declared) to and including the date of payment. Until the holders of the Series A Preferred Stock have been paid the Liquidation Preference in full, plus an amount equal to all accumulated, accrued and unpaid dividends (whether or not earned or declared) to the date of final distribution to such holders, no payment will be made to any holder of Junior Stock upon the liquidation, dissolution or winding up of the Corporation. If upon the voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the available assets of the Corporation, or proceeds thereof, distributable among the holders of the Series A Preferred Stock shall be insufficient to pay in full the above described preferential amount and liquidating payments on any other shares of any class or series of Parity Stock, then such assets, or the proceeds thereof, shall be distributed among the holders of the Series A Preferred Stock and any such other Parity Stock ratably in the same proportion as the respective amounts that would be payable on such Series A Preferred Stock and any such other Parity Stock if all amounts payable thereon were paid in full. After payment of the full amount of the liquidation distributions to which they are entitled, the holders of the Series A Preferred Stock shall have no right or claim to any of the remaining assets of the Corporation.

(b) Written notice of any such liquidation, dissolution or winding up of the Corporation, stating the payment date or dates when, and the place or places where the amounts distributable in such circumstances shall be payable, shall be given by first class mail, postage pre-paid, not less than 30 nor more than 60 days prior to the payment date stated therein, to each record holder of the shares of the Series A Preferred Stock at the respective addresses of such holders as the same shall appear on the stock transfer records of the Corporation.

(c) Upon any liquidation, dissolution or winding up of the Corporation, after payment shall have been made in full to the

holders of the Series A Preferred Stock and any Parity Stock, any other series or class or classes of Junior Stock shall be entitled to receive any and all assets of the Corporation remaining to be paid or distributed, and the holders of the Series A Preferred Stock and any Parity Stock shall not be entitled to share therein.

(d) The consolidation or merger of the Corporation with or into any other corporation, trust or entity or of any other corporation with or into the Corporation, or the sale or transfer of all or substantially all of the assets or business of the Corporation or a statutory share exchange, shall not be deemed to constitute a voluntary or involuntary liquidation, dissolution or winding up of the Corporation.

(e) In determining whether a distribution (other than upon voluntary or involuntary liquidation), by dividend, redemption or other acquisition of shares of stock of the Corporation or otherwise, is permitted under the Maryland General Corporation Law, amounts that would be needed, if the Corporation were to be dissolved at the time of distribution, to satisfy the preferential rights upon dissolution of holders of shares of the Series A Preferred Stock shall not be added to the Corporation's total liabilities.

(5) *Redemption.*

(a) The Series A Preferred Stock is not redeemable prior to February 18, 2009. However, in order to ensure that the Corporation remains a qualified REIT for Federal income tax purposes, the Series A Preferred Stock shall be subject to the provisions of Article VII of the Charter. Pursuant to Article VII of the Charter, and without limitation of any provisions of such Article VII, the Series A Preferred Stock, together with all other Stock (as defined in the Charter), owned by a stockholder in excess of the Aggregate Stock Ownership Limit (as defined in the Charter) will automatically be transferred to a Trust (as defined in the Charter) for the benefit of a Charitable Beneficiary (as defined in the Charter) and the Corporation shall have the right to purchase such transferred shares from the Trust. On and after February 18, 2009, the Corporation may, at its option, redeem shares of the Series A Preferred Stock, in whole or from time to time,

in part, for cash at a redemption price of \$25.00 per share, plus all accumulated, accrued and unpaid dividends, if any, to and including the date fixed for redemption (the "Redemption Date").

(b) In the event of a redemption of shares of the Series A Preferred Stock, if the Redemption Date occurs after a Dividend Record Date and on or prior to the related Dividend Payment Date, the dividend payable on such Dividend Payment Date in respect of such shares called for redemption shall be payable on such Dividend Payment Date to the holders of record at the close of business on such Dividend Record Date, and shall not be payable as part of the redemption price for such shares.

(c) The Redemption Date shall be selected by the Corporation and shall be not less than 30 days nor more than 60 days after the date on which the Corporation sends the notice of redemption.

(d) If full cumulative dividends on all outstanding shares of the Series A Preferred Stock have not been paid or declared and set apart for payment, no shares of the Series A Preferred Stock may be redeemed unless all outstanding shares of the Series A Preferred Stock are simultaneously redeemed, and neither the Corporation nor any of its affiliates may purchase or acquire shares of the Series A Preferred Stock otherwise than pursuant to a purchase or exchange offer made on the same terms to all holders of the Series A Preferred Stock.

(e) If fewer than all of the outstanding shares of the Series A Preferred Stock is to be redeemed, the Corporation shall select those shares to be redeemed pro rata or by lot or in such manner as the Board of Directors may determine.

(f) The Corporation shall give notice of redemption by publication in a newspaper of general circulation in the City of New York, such publication to be made once a week for two successive weeks commencing not less than 30 nor more than 60 days prior to the Redemption Date. The Corporation shall mail notice of redemption of the Series A Preferred Stock to each holder of record of the shares to be redeemed by first class mail, postage prepaid, not less than 30 nor more than 60 days prior to the Redemption Date, at such holder's address as the same appears on the stock records of the Corporation. Any notice which was mailed as described above shall be conclusively presumed to have been duly given on the date mailed whether or not the holder receives the notice. Each notice shall state: (1) the Redemption Date; (2) the number of shares of the Series A Preferred Stock to be redeemed in total and from such holder; (3) the place or places where certificates for the shares of the Series A Preferred Stock are to be surrendered for payment of the redemption price; (4) the redemption price payable on the Redemption Date, including, without limitation, a statement as to whether or not accumulated, accrued and unpaid dividends shall be payable as part of the redemption price, or payable on the next Dividend Payment Date to the record holder at the close of business on the relevant record date as described above; and (5) that dividends on the shares of the Series A Preferred Stock to be redeemed shall cease to accrue on such Redemption Date.

(g) From and after the Redemption Date (unless the Corporation defaults in the payment of its redemption obligation), dividends on the shares of the Series A Preferred Stock to be redeemed shall cease to accumulate or accrue, the shares shall no longer be deemed to be outstanding and all rights of the holders thereof shall cease, except the right to receive the cash payable upon such redemption without interest thereon. If the Redemption Date occurs after a Dividend Record Date and on or prior to the related Dividend Payment Date, each holder of the Series A Preferred Stock at the close of business on the record date shall have the right to receive the dividend payable on the Dividend Payment Date. Upon surrender in accordance with such notice of the certificates representing the Series A Preferred Stock (properly endorsed or assigned for transfer, if the Board of Directors shall so require and the notice shall so state), the redemption price set forth above shall be paid out of the funds provided by the Corporation. If fewer than all the shares

represented by any such certificate are redeemed, a new certificate shall be issued representing the unredeemed shares without cost to the holder thereof.

(h) Subject to applicable law and the limitation on purchases when dividends on the Series A Preferred Stock are in arrears, the Corporation may, at any time and from time to time, purchase any shares of the Series A Preferred Stock in the open market, by tender or by private agreement.

(i) The shares of the Series A Preferred Stock are subject to the provisions of Article VII of the Charter, including, without limitation, the provision for the redemption of shares transferred to the Trust (as defined in the Charter). For this purpose, the Market Price of Series A Preferred Stock shall equal \$25.00 per share, plus an amount equal to all accumulated, accrued and unpaid dividends (whether or not earned or declared) to and including the date of redemption.

(j) Any shares of Series A Preferred Stock that shall at any time have been redeemed or otherwise acquired by the Corporation shall, after such redemption or acquisition, have the status of authorized but unissued Preferred Stock, without designation as to series until such shares are once more classified and designated as part of a particular series by the Board of Directors.

(6) *Voting Rights.*

(a) Holders of the Series A Preferred Stock shall not have any voting rights, except as set forth below. If and whenever dividends on any shares of the Series A Preferred Stock shall be in arrears for six or more quarterly periods, whether or not consecutive, the number of directors then constituting the Board of Directors shall be increased by two, if not already increased by reason of similar types of provisions with respect to shares of Parity Stock of any other class or series which is entitled to similar voting rights (the "Voting Preferred Stock"), and the holders of shares of the Series A Preferred Stock, together with the holders of shares of all other Voting Preferred Stock then entitled to exercise similar voting rights, voting as a single class regardless of series, shall be entitled to vote for the election of the two additional directors of the Corporation, or fill any vacancy, at any annual meeting of stockholders or at a special meeting of the holders of the Series A Preferred Stock and of the Voting Preferred Stock called for that purpose. The Corporation must call such special meeting upon the request of holders of at least 20% of the shares of the Series A Preferred Stock then outstanding. In the case of such a written request, such special meeting shall be held within 90 days after the delivery of such request and, in either case, at the place and upon the notice provided by law and in the Bylaws, provided that the Corporation shall not be required to call such a special meeting if such request is received less than 120 days before the date fixed for the next annual meeting of stockholders, and the holders of all classes of outstanding Voting Preferred Stock are offered the opportunity to elect such directors, or fill any vacancy, at such annual meeting of stockholders. Directors so elected shall serve until the next annual meeting of stockholders or until their respective successors are elected and qualified. If, prior to the end of the term of any director so elected, a vacancy in the office of such director shall occur, during the continuance of a default in dividends on the Series A Preferred Stock and/or Voting Preferred Stock, by reason of death, resignation, or disability, such vacancy shall be filled for the unexpired term of such former director by the election of a new director by the remaining director or directors so elected. If and whenever dividends in arrears on outstanding shares of the Series A Preferred Stock and any other shares of Voting Preferred Stock have been paid and dividends thereon for the current quarterly dividend period shall have been paid or declared and set apart for payment, then the right of the holders of the Series A Preferred Stock and of such other Voting Preferred Stock to elect the additional two directors shall cease and the terms of office of the directors shall terminate and the number of directors constituting the Board of Directors shall be reduced accordingly.

(b) The affirmative vote or consent of at least two-thirds of the votes entitled to be cast by the holders of the outstanding shares of the Series A Preferred Stock and the holders of all other

classes or series of Parity Stock entitled to vote on such matters, voting as a single class, shall be required to (i) authorize, create, increase the authorized amount of or issue any shares of any class of Senior Stock or any security convertible into shares of any class of Senior Stock, or reclassify any of the outstanding Parity Stock or Junior Stock into shares of such Senior Stock, or (ii) amend, alter or repeal any provision of the Charter or Bylaws, whether by merger, consolidation or otherwise, if such action would materially adversely affect the rights, preferences, privileges, or voting powers of the Series A Preferred Stock; provided, however, that no such vote of the holders of the Series A Preferred Stock shall be required if, at or prior to the time such amendment, alteration or repeal is to take effect or the issuance of any such Senior Stock or convertible security is to be made, as the case may be, provisions are made for the redemption of all outstanding shares of the Series A Preferred Stock; provided further, however, with respect to the occurrence of any event set forth in (ii) above, so long as the Series A Preferred Stock remains outstanding with the terms thereof materially unchanged, the occurrence of any such event shall not be deemed to materially adversely affect such rights, preferences, privileges or voting powers of the Series A Preferred Stock and, provided further, that any increase in the amount of the authorized Preferred Stock, including the Series A Preferred Stock, or the creation or issuance of any additional Series A Preferred Stock or other series of Preferred Stock, or any increase in the amount of authorized shares of such series, in each case ranking on a parity with or junior to the Series A Preferred Stock with respect to payment of dividends or the distribution of assets upon liquidation, dissolution or winding up, shall not be deemed to materially adversely affect such rights, preferences, privileges or voting powers.

For the purposes of the foregoing provisions, each share of the Series A Preferred Stock shall have one vote per share, except that when any other class or series of Preferred Stock shall have the right to vote with the Series A Preferred Stock as a single series, then the Series A

Preferred Stock and such other class or series shall have one quarter of one vote per each \$25.00 of stated liquidation preference.

(7) *Conversion.* The Series A Preferred Stock is not convertible into or exchangeable for any other property or securities of the Corporation.

*SECOND:* The shares of Series A Preferred Stock have been classified and designated by the Board of Directors under the authority contained in the Charter.

*THIRD:* These Articles Supplementary have been approved by the Board of Directors in the manner and by the vote required by law.

*FOURTH:* The undersigned President of the Corporation acknowledges these Articles Supplementary to be the corporate act of the Corporation and, as to all matters or facts required to be verified under oath, the undersigned President acknowledges that, to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties of perjury.

IN WITNESS WHEREOF, the Corporation has caused these Articles Supplementary to be signed in its name and on its behalf by its President and attested to by its Secretary on this 16<sup>th</sup> day of February, 2004.

ATTEST: AFFORDABLE RESIDENTIAL COMMUNITIES INC.

By: /s/ Scott L. Gesell  
Name: Scott L. Gesell  
Title: Secretary

By: /s/ George McGeeney  
Name: George McGeeney  
Title: President

**AFFORDABLE RESIDENTIAL COMMUNITIES INC.**  
**CERTIFICATE OF NOTICE**

THIS IS TO CERTIFY THAT:

*FIRST:* The Board of Directors of Affordable Residential Communities Inc., a Maryland corporation (the "Corporation"), pursuant to Section 7.2.8 of the charter of the Corporation (the "Charter"), has (a) increased the Aggregate Stock Ownership Limit and the Common Stock Ownership Limit (each as defined in the Charter) to 19.9% for one Individual (as defined in the Charter) and any entities owned or controlled by such Individual and any directors or executive officers of any such entities owned or controlled by such Individual and (b) decreased the Aggregate Stock Ownership Limit and the Common Stock Ownership Limit to 7.3% for all other Individuals.

*SECOND:* The undersigned Chief Executive Officer acknowledges this Certificate of Notice to be the corporate act of the Corporation and as to all matters or facts required to be verified under oath, the undersigned Chief Executive Officer acknowledges that to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties for perjury.

IN WITNESS WHEREOF, the Corporation has caused this Certificate of Notice to be signed in its name and on its behalf by its Chief Executive Officer and attested to by its Secretary on this 6<sup>th</sup> day of June, 2005.

ATTEST: AFFORDABLE RESIDENTIAL COMMUNITIES INC.

By: /s/ Scott L. Gesell  
Name: Scott L. Gesell  
Title: Secretary

By: /s/ Scott D. Jackson (SEAL)  
Name: Scott D. Jackson  
Title: Chief Executive Officer

**AFFORDABLE RESIDENTIAL COMMUNITIES INC.**  
**ARTICLES OF AMENDMENT**

Affordable Residential Communities Inc., a Maryland corporation (the "Corporation"), hereby certifies to the State Department of Assessments and Taxation of Maryland that:

*FIRST:* The charter of the Corporation is hereby amended by deleting therefrom Section 5.7 and inserting in lieu thereof the following Section 5.7:

Section 5.7 Reserved.

*SECOND:* The charter of the Corporation is hereby amended by deleting therefrom Article VII and inserting in lieu thereof the following Article VII:

**ARTICLE VII**  
**RESTRICTION ON TRANSFER AND OWNERSHIP OF SHARES**

Section 7.1 Definitions. For purposes of this Article VII, the following terms shall have the following meanings:

Agent. The term “Agent” shall mean an agent designated by the Board of Directors of the Corporation.

Corporation Securities. The term “Corporation Securities” shall mean (a) shares of Common Stock, (b) shares of Special Voting Stock, (c) shares of Preferred Stock, (d) warrants, rights, or options (within the meaning of Treasury Regulation Section 1.382-4(d)(9)) to purchase stock of the Corporation and (e) any other interests that would be treated as “stock” of the Corporation pursuant to Treasury Regulation Section 1.382-2T(f)(18), or any successor provision.

Effective Date. The term “Effective Date” shall mean the date of filing of this amendment.

Excess Securities. The term “Excess Securities” shall mean the Corporation Securities which are the subject of the Prohibited Transfer.

Five-Percent Shareholder. The term “Five-Percent Shareholder” shall mean a Person or group of Persons that is identified as a “5-percent shareholder” of the Corporation pursuant to Treasury Regulation Section 1.382-2T(g).

NYSE. The term “NYSE” shall mean the New York Stock Exchange.

Percentage Stock Ownership. The term “Percentage Stock Ownership” shall mean percentage stock ownership as determined in accordance with Treasury Regulation Sections 1.382-2T(g),(h), (j) and (k).

Person. The term “Person” shall mean an individual, corporation, estate, trust, association, limited liability company, partnership, joint venture or similar organization.

Prohibited Distributions. The term “Prohibited Distributions” shall mean any dividends or other distributions that were paid by the Corporation and received by a Purported Transferee with respect to the Excess Securities.

Prohibited Transfer. The term “Prohibited Transfer” shall mean any purported Transfer of Corporation Securities to the extent that such Transfer is prohibited and/or void under this Article VII.

Purported Transferee. The term “Purported Transferee” shall mean the purported transferee of a Prohibited Transfer.

Restriction Release Date. The term “Restriction Release Date” shall mean the earliest of (a) the repeal of Section 382 of the Code (and any comparable successor provision), (b) the date on which the Board of Directors determines that no Tax Benefits may be carried forward to the taxable year of the Corporation (or any successor thereof) in which such determination is made and does not project

---

material Tax Benefits for subsequent years or (c) the Board of Directors determines that the restrictions contained in this Article VII are no longer in the best interests of the Corporation.

Section 501(c)(3). The term “Section 501(c)(3)” shall mean Section 501(c)(3) of the Code (or any comparable successor provision).

Tax Benefits. The term “Tax Benefits” shall mean the net operating loss carryovers, capital loss carryovers, general business credit carryovers, alternative minimum tax credit carryovers and foreign tax credit carryovers, as well as any “net unrealized built-in loss” within the meaning of Section 382 of the Code, of the Corporation or any direct or indirect subsidiary thereof.

Transfer. The term “Transfer” shall mean, subject to the last sentence of this definition, any direct or indirect sale, transfer, assignment, conveyance, pledge, or other disposition. A Transfer also shall include the creation or grant of an option (within the meaning of Treasury Regulation Section 1.382-4(d)(9)) other than the grant of an option by the Corporation or the modification, amendment or adjustment of an existing option granted by the Corporation. A Transfer shall not include an issuance or grant of Corporation Securities by the Corporation, the modification, amendment or adjustment of an existing option by the Corporation and the exercise by an employee of the Corporation of any option to purchase Corporation Securities granted to such employee pursuant to contract or any stock option plan or other equity compensation plan of the Corporation.

Treasury Regulation. The term “Treasury Regulation” shall mean the income tax regulations (whether temporary, proposed or final) promulgated under the Code and any successor regulations. References to any subsection of such regulations include references to any successor subsection thereof.

Section 7.2 Restrictions on Transfer. Subject to Section 7.3, any attempted Transfer of Corporation Securities prior to the Restriction Release Date, or any attempted Transfer of Corporation Securities pursuant to an agreement entered into prior to the Restriction Release Date, shall be prohibited and void *ab initio* to the extent that, as a result of such Transfer (or any series of Transfers of which such Transfer is a part), either (a) any Person or group of Persons shall become a Five-Percent Shareholder, or (b) the Percentage Stock Ownership interest in the Corporation of any Five-Percent Shareholder shall be increased. Notwithstanding the foregoing, nothing in this Article VII shall prevent a Person from Transferring Corporation Securities to any Person to the extent that such Transfer, if effective, would cause an increase in the Percentage Stock Ownership of a public group of the Corporation, as defined in Treasury Regulation Section 1.382-2T(f)(13) of any successor regulation.



Section 7.3 Certain Exceptions. The restrictions set forth in Section 7.2 of this Article VII shall not apply to (a) an attempted Transfer of Common Stock by Gerald J. Ford or his Affiliates or Associates (as such terms are defined in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended) unless such Transfer would result in Gerald J. Ford and his Affiliates and Associates becoming an owner of more than 21% of the shares of Common Stock then outstanding for purposes of Section 382 of the Code or (b) an attempted Transfer of Corporation Securities if the transferor or the transferee obtains the written approval of the Board of Directors of the Corporation, which approval may be granted or denied in the sole discretion of the Board of Directors and may be granted prospectively or retroactively. As a condition to granting its approval, the Board of Directors may, in its discretion, require (at the expense of the transferor and/or transferee) an opinion of counsel selected by the Board of Directors that the Transfer shall not result in the application of any Section 382 limitation on the use of the Tax Benefits.

Section 7.4 Treatment of Excess Securities.

(a) No officer, director, employee or agent of the Corporation shall record any Prohibited Transfer, and a Purported Transferee shall not be recognized as a stockholder of the Corporation for any purpose whatsoever in respect of Excess Securities. Until the Excess Securities are acquired by another Person in a Transfer that is not a Prohibited Transfer, the Purported Transferee shall not be

2

---

entitled with respect to such Excess Securities to any rights of stockholders of the Corporation, including, without limitation, the right to vote such Excess Securities and to receive dividends or distributions, whether liquidating or otherwise, in respect thereof, if any. Once the Excess Securities have been acquired in a Transfer that is not a Prohibited Transfer, the Securities shall cease to be Excess Securities.

(b) If the Board of Directors determines that a Transfer of Corporation Securities constitutes a Prohibited Transfer then, upon written demand by the Corporation, the Purported Transferee shall transfer or cause to be transferred any certificate or other evidence of ownership of the Excess Securities within the Purported Transferee's possession or control, together with Prohibited Distributions, to the Agent. The Agent shall thereupon sell to a buyer or buyers, which may include the Corporation, the Excess Securities transferred to it in one or more arm's-length transactions (over the NYSE or another national securities exchange on which the Corporation Securities may be traded, if possible); provided, however, that the Agent shall effect such sale or sales in an orderly fashion and shall not be required to effect any such sale within any specific time frame if, in the Agent's discretion, such sale or sales would disrupt the market for the Corporation Securities or otherwise would adversely affect the value of the Corporation Securities. If the Purported Transferee has resold the Excess Securities before receiving the Corporation's demand to surrender the Excess Securities to the Agent, the Purported Transferee shall be deemed to have sold the Excess Securities for the Agent, and shall be required to transfer to the Agent any Prohibited Distributions and proceeds of such sale, except to the extent that the Corporation grants written permission to the Purported Transferee to retain a portion of such sales proceeds not exceeding the amount that the Purported Transferee would have received from the Agent pursuant to Section 7.4(c) of this Article VII if the Agent rather than the Purported Transferee had resold the Excess Securities.

(c) The Agent shall apply any proceeds of a sale by it of Excess Securities, and if the Purported Transferee had previously resold the Excess Securities, any amounts received by the Agent from a Purported Transferee, as follows: (i) first, such amounts shall be paid to the Agent to the extent necessary to cover its costs and expenses incurred in connection with its duties hereunder; (ii) second, any remaining amounts shall be paid to the Purported Transferee, up to the lesser of (A) the amount paid by the Purported Transferee for the Excess Securities or (B) the fair market value of the Excess Securities at the time of the attempted Transfer (1) calculated on the basis of the closing market price for the Corporation Securities on the day before the Transfer, (2) if the Corporation Securities are not listed or admitted to trading on any stock exchange but are traded in the over-the-counter market, calculated based upon the difference between the highest bid and lowest asked prices, as such prices are reported by the National Association of Securities Dealers through its NASDAQ system or any successor system on the day before the Transfer or, if none, on the last preceding day for which such quotations exist or (3) if the Corporation Securities are neither listed nor admitted to trading on any stock exchange nor traded in the over-the-counter market, then as determined in good faith by the Board of Directors, and (iii) third, any remaining amounts, subject to the limitations imposed by the following proviso, shall be paid to one or more organizations qualifying under Section 501(c)(3) selected by the Board of Directors. The recourse of any Purported Transferee in respect of any Prohibited Transfer shall be limited to the amount payable to the Purported Transferee pursuant to clause (ii) of the preceding sentence. In no event shall the proceeds of any sale of Excess Securities pursuant to this Article VII inure to the benefit of the Corporation.

Section 7.5 Board Determinations. The Board of Directors of the Corporation shall have the power to determine all matters necessary for determining compliance with this Article VII, including, without limitation: (a) the identification of Five-Percent Shareholders; (b) whether a Transfer is a Prohibited Transfer; (c) the Percentage Stock Ownership in the Corporation of any Five-Percent Shareholder; (d) whether an instrument constitutes a Corporation Security; (e) the amount (or fair market value) due to a Purported Transferee pursuant to clause 7.4(c)(ii) of this Article VII;

3

---

(f) whether compliance with any restriction or limitation on stock ownership and transfers set forth in this Article VII is no longer required; (g) in the case of an ambiguity in the application of any of the provisions of this Article VII or otherwise, the application of the provisions of this Article VII with respect to any situation; and (h) any other matters which the Board of Directors determines to be relevant; and the determination of the Board of Directors on such matters shall be conclusive and binding for all the purposes of this Article VII.

Section 7.6 NYSE Transactions. Nothing in this Article VII shall preclude the settlement of any transaction entered into through the facilities of the NYSE or any other national securities exchange or automated inter-dealer quotation system. The fact that the settlement of any transaction occurs shall not negate the effect of any other provision of this Article VII and any Purported Transferee in such a transaction shall be

subject to all of the provisions and limitations set forth in this Article VII.

Section 7.7 Enforcement. The Corporation is authorized specifically to seek equitable relief, including injunctive relief, to enforce the provisions of this Article VII.

Section 7.8 Non-Waiver. No delay or failure on the part of the Corporation or the Board of Directors in exercising any right hereunder shall operate as a waiver of any right of the Corporation or the Board of Directors, as the case may be, except to the extent specifically waived in writing.

Section 7.9 Notice to Corporation. Any Person who acquires or attempts to acquire Corporation Securities in excess of the limitations set forth in this Article VII shall immediately give written notice to the Corporation of such event and shall provide to the Corporation such other information as the Corporation may request in order to determine the effect, if any, of such purported transfer on the preservation and usage of the Tax Benefits.

Section 7.10 Bylaws. The Bylaws may make appropriate provisions to effectuate the requirements of this Article VII.

Section 7.11 Certificates. All certificates representing Corporation Securities issued after the effectiveness of this Article VII shall bear a conspicuous legend summarizing the restrictions set forth in this Article VII.

THIRD: The amendment to the charter of the Corporation as set forth above have been duly advised by the Board of Directors and approved by the stockholders of the Corporation as required by law.

FOURTH: The undersigned President acknowledges these Articles of Amendment to be the corporate act of the Corporation and as to all matters of facts required to be verified under oath, the undersigned President acknowledges that to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties of perjury.

IN WITNESS WHEREOF, the Corporation has caused these Articles of Amendment to be executed under seal in its name and on its behalf by its President, and attested to by its Corporate Secretary, on this 23<sup>rd</sup> day of January, 2007.

ATTEST:

AFFORDABLE RESIDENTIAL COMMUNITIES INC.

/s/ Scott L. Gesell  
Name: Scott L. Gesell  
Title: Corporate Secretary

By: /s/ James F. Kimsey (SEAL)  
Name: James F. Kimsey  
Title: President

**AFFORDABLE RESIDENTIAL COMMUNITIES INC.**  
**ARTICLES OF AMENDMENT**

THIS IS TO CERTIFY THAT:

FIRST: The charter of Affordable Residential Communities Inc., a Maryland corporation (the "Corporation"), is hereby amended by deleting existing Article II in its entirety and substituting in lieu thereof a new article to read as follows:

**ARTICLE II**  
**NAME**

The name of the corporation (the "Corporation") is:

Hilltop Holdings Inc.

SECOND: The amendment to the charter of the Corporation as set forth above has been duly approved by at least a majority of the entire Board of Directors as required by law. The amendment set forth herein is made without action by the stockholders of the Corporation, pursuant to Section 2-605(a)(1) of the Maryland General Corporation Law.

THIRD: The undersigned President acknowledges these Articles of Amendment to be the corporate act of the Corporation and as to all matters or facts required to be verified under oath, the undersigned President acknowledges that to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties for perjury.

IN WITNESS WHEREOF, the Corporation has caused these Articles of Amendment to be signed in its name and on its behalf by its President and attested to by its Secretary on this 31<sup>st</sup> day of July, 2007.

ATTEST:

AFFORDABLE RESIDENTIAL COMMUNITIES INC.

By: /s/ Scott L. Gessell  
Name: Scott L. Gessell  
Title: Secretary

By: /s/ James F. Kimsey (SEAL)  
Name: James F. Kimsey  
Title: President

---

**HILLTOP HOLDINGS INC.**

**CERTIFICATE OF NOTICE**

THIS IS TO CERTIFY THAT:

FIRST: The Board of Directors of Hilltop Holdings Inc., a Maryland corporation (the "Corporation"), pursuant to Section 7.3 of the charter of the Corporation, has granted its approval for Gerald J. Ford or his Affiliates or Associates (as such terms are defined in Rule 12b-2 of the General Rules and Regulations under the Securities Exchange Act of 1934, as amended) to become an owner of up to 30% of the shares of Common Stock, \$.01 par value per share, of the Corporation then outstanding for purposes of Section 382 of the Internal Revenue Code of 1986, as amended.

SECOND: The undersigned Chief Executive Officer acknowledges that this Certificate of Notice to be the corporate act of the Corporation and as to all matters or facts required to be verified under oath, the undersigned Chief Executive Officer acknowledges that to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties of perjury.

IN WITNESS WHEREOF, the Corporation has caused this Certificate of Notice to be signed in its name and on its behalf by its Chief Executive Officer and attested to by its Secretary on this 23<sup>rd</sup> day of September 2008.

ATTEST:

HILLTOP HOLDINGS INC.

By: /s/ COREY G. PRESTIDGE  
Name: Corey G. Prestidge  
Title: Secretary

By: /s/ LARRY D. WILLARD (SEAL)  
Name: Larry D. Willard  
Title: Chief Executive Officer

---

**HILLTOP HOLDINGS INC.**

**ARTICLES SUPPLEMENTARY**

Hilltop Holdings Inc., a Maryland corporation (the "Corporation"), hereby certifies to the State Department of Assessments and Taxation of Maryland that:

FIRST: Under a power contained in Section 6.4 of Article VI of the charter of the Corporation (the "Charter"), the Board of Directors of the Corporation (the "Board of Directors"), by resolution duly adopted at a meeting duly called and held on November 4, 2010, reclassified and designated 750,000 authorized but unissued shares of the Corporation's 8.25% Series A Cumulative Redeemable Preferred Stock, \$.01 par value per share (the "Shares"), as authorized but unissued shares of the Corporation's Preferred Stock, \$.01 par value per share (the "Preferred Stock").

SECOND: A description of the Preferred Stock is contained in Section 6.4 of Article VI of the Charter.

THIRD: The Shares have been reclassified and designated by the Board of Directors under the authority contained in the Charter.

FOURTH: These Articles Supplementary have been approved by the Board of Directors in the manner and by the vote required by law.

FIFTH: The undersigned acknowledges these Articles Supplementary to be the corporate act of the Corporation and, as to all matters or facts required to be verified under oath, the undersigned acknowledges that, to the best of his knowledge, information and belief, these matters and facts are true in all material respects and that this statement is made under the penalties for perjury.

[signatures on next page]

---

IN WITNESS WHEREOF, the Corporation has caused these Articles Supplementary to be executed under seal in its name and on its behalf by its Chief Executive Officer and President, and attested to by its Secretary, on this 15<sup>th</sup> day of December 2010.

ATTEST:

HILLTOP HOLDINGS INC.

[\(Back To Top\)](#)

### Section 3: EX-10.2.3 (EX-10.2.3)

Exhibit 10.2.3

**HILLTOP HOLDINGS INC.  
2003 EQUITY INCENTIVE PLAN  
NON-QUALIFIED STOCK OPTION AGREEMENT**

THIS NONQUALIFIED STOCK OPTION AGREEMENT (the "Agreement"), dated as of \_\_\_\_\_, is made by and between Hilltop Holdings Inc., a Maryland corporation (the "Company"), and \_\_\_\_\_ (the "Optionee").

WHEREAS, the Company has adopted the 2003 Equity Incentive Plan (the "Plan"), pursuant to which options may be granted to purchase Common Stock;

WHEREAS, the Company desires to grant to the Optionee a nonqualified stock option to purchase the number of shares of Common Stock provided for herein;

NOW, THEREFORE, in consideration of the recitals and the mutual agreements herein contained, the parties hereto agree as follows:

**Section 1. Grant of Option**

(a) *Grant of Option.* The Company hereby grants to the Optionee an Option to purchase \_\_\_\_\_ shares of Common Stock on the terms and conditions set forth in this Agreement and as otherwise provided in the Plan. The Option is *not* intended to be treated, and shall not be construed, as an Incentive Stock Option.

(b) *Incorporation of Plan.* The provisions of the Plan are hereby incorporated herein by reference. Except as otherwise expressly set forth herein, this Agreement shall be construed in accordance with the provisions of the Plan and any capitalized terms not otherwise defined in this Agreement shall have the definitions set forth in the Plan. The Committee shall have final authority to interpret and construe the Plan and this Agreement and to make any and all determinations under them, and its decision shall be binding and conclusive upon the Optionee and his/her legal representative in respect of any questions arising under the Plan or this Agreement.

**Section 2. Terms and Conditions of Option**

(a) *Exercise Price.* The price at which the Optionee shall be entitled to purchase shares of Stock upon the exercise of all or any portion of the Option shall be \$ \_\_\_\_\_ per share.

(b) *Expiration Date.* The Option shall expire at the close of business on the tenth anniversary of the date of this Agreement.

(c) *Exercisability of Option.*

(i) Subject to the other terms of this Agreement regarding the vesting and exercisability of the Option, the Option shall become vested and exercisable as of the dates set forth below for the cumulative percentages of shares of Common Stock set forth below, provided the Optionee is employed by the Company or an Affiliate as of each such date:

Date	Percentage of Shares

The Committee may, but shall not be required to, provide at any time for the acceleration of the schedule set forth above.

(ii) Notwithstanding clause (i) above, in the event that the Optionee's employment with the Company and its Affiliates is terminated because of the Optionee's death the Option shall become fully vested and exercisable as of the effective date of such termination.

(iii) Notwithstanding any other provision of this Agreement, the Option shall become fully vested and exercisable as of a Change in Control.

(d) *Method of Exercise.* The Option may be exercised only by written notice in such form as the Company may adopt from time to time, delivered in person or by mail in accordance with Section 3(a) and accompanied by payment therefor or pursuant to such other procedure as the Company may adopt from time to time. The purchase price of the shares of Common Stock shall be paid to the Company (i) in cash or its equivalent, (ii) by tendering to the Company shares of Common Stock already owned by the Optionee having a total Fair Market Value less than or equal to the aggregate purchase price, (iii) to the extent permitted by law, by a “broker cashless exercise” procedure approved by the Committee, or (iv) by a combination of the foregoing methods. If requested by the Committee, the Optionee shall deliver this Agreement evidencing the Option to the Secretary of the Company who shall endorse thereon a notation of such exercise and return such Agreement to the Optionee. A minimum of 100 shares of Common Stock must be purchased upon the exercise of the Option unless a lesser number of shares of Common

Stock so purchased constitutes the total number of shares of Common Stock then purchasable under the Option.

(e) *Exercise Following Termination of Employment.* In the event that the Optionee ceases to be employed by the Company or an Affiliate, that portion of the Option that is not or does not become then exercisable shall immediately terminate and that portion of the Option that is or becomes exercisable at the time of the Optionee’s termination of employment shall terminate as follows:

(i) If the Optionee’s termination of employment is due to his/her death or disability (within the meaning of the Company’s long-term disability plan), the Option (to the extent exercisable at the time of the Optionee’s termination of employment) shall be exercisable for a period of twelve months following such termination of employment, and shall thereafter terminate;

(ii) If the Optionee’s termination of employment is by the Company or an Affiliate for Cause, the Option shall terminate on the date of the Optionee’s termination of employment;

(iii) If the Optionee voluntarily terminates his/her employment with the Company and its Affiliates, the Option (to the extent exercisable at the time of the Optionee’s termination) shall be exercisable for a period of 60 days following such termination of employment, and shall thereafter terminate; and

(iv) If the Optionee’s termination of employment is for any other reason, the Option (to the extent exercisable at the time of the Optionee’s termination of employment) shall be exercisable for a period of 60 days following such termination of employment, and shall thereafter terminate.

Notwithstanding the foregoing, no provision in this Section 2(e) shall extend the exercise period of an Option beyond its original term set forth in Section 2(b).

(f) *Nontransferability.* The Option shall not be transferable by the Optionee other than by will or the laws of descent and distribution.

(g) *Rights as a Stockholder.* The Optionee shall not be deemed for any purpose to be the owner of any shares of Stock subject to the Option unless, until and to the extent that (i) the Option shall have been exercised pursuant to its terms, (ii) the Company shall have issued and delivered to the Optionee the shares of Stock for which the Option shall have been exercised, and (iii) the Optionee’s name shall have been entered as a stockholder of record with respect to such shares of Stock on the books of the Company.

(i) *Income Taxes.* The Company may, in its discretion, require that the Optionee pay to the Company at or after (as determined by the Committee) the time of

exercise of any portion of the Option any such additional amount as the Company deems necessary to satisfy its liability to withhold federal, state or local income tax or any other taxes incurred by reason of the exercise or the transfer of shares of Common Stock thereupon. The Optionee may elect to satisfy part of this obligation by requesting that the Company withhold a portion of the shares of Common Stock to be received upon the exercise of the Option having a Fair Market Value equal to the minimum amount required to be withheld. For purposes of this Agreement, the Fair Market Value of the shares of Common Stock to be so withheld shall be calculated on the date on which the amount of tax to be withheld is determined.

### Section 3. **Miscellaneous**

(a) *Notices.* Unless otherwise determined by the Committee, any and all notices, designations, consents, offers, acceptances and any other communications provided for herein shall be given in writing and shall be delivered either personally or by registered or certified mail, postage prepaid, which shall be addressed, in the case of the Company to the General Counsel of the Company at the principal office of the Company and, in the case of the Optionee, to Optionee’s address appearing on the books of the Company or to Optionee’s residence or to such other address as may be designated in writing by the Optionee.

(b) *No Right to Continued Employment.* Nothing in the Plan or in this Agreement shall confer upon the Optionee any right to continue in the employ of the Company or any Affiliate or shall interfere with or restrict in any way the right of the Company and its Affiliates, which are hereby expressly reserved, to remove, terminate or discharge the Optionee at any time for any reason whatsoever, with or without Cause.

(c) *Bound by Plan.* By signing this Agreement, the Optionee acknowledges that he/she has received a copy of the Plan and has had an opportunity to review the Plan and agrees to be bound by all the terms and provisions of the Plan.

(d) *Successors.* The terms of this Agreement shall be binding upon and inure to the benefit of the Company, its successors and assigns, and of the Optionee and the beneficiaries, executors, administrators, heirs and successors of the Optionee.

(e) *Validity/Invalidity.* The invalidity or unenforceability of any particular provision hereof shall not affect the other provisions hereof, and this Agreement shall be construed in all respects as if such invalid or unenforceable provision had been omitted.

(f) *Modifications.* No adverse change or modification of any provision of this Agreement shall be valid, and no waiver of any provision of this Agreement shall be valid, unless the same be in writing and signed by the parties hereto.

(g) *Entire Agreement.* This Agreement and the Plan contain the entire agreement and understanding of the parties hereto with respect to the subject matter

4

---

contained herein and therein and supersede all prior communications, representations and negotiations in respect thereto.

(h) *Governing Law.* This Agreement and the rights of the Optionee hereunder shall be construed and determined in accordance with the laws of the State of Maryland.

(i) *Headings.* The headings of the Sections hereof are provided for convenience only and are not to serve as a basis for interpretation or construction, and shall not constitute a part, of this Agreement.

(j) *Counterparts.* This Agreement may be executed in counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

5

---

IN WITNESS WHEREOF, this Agreement has been executed and delivered by the parties hereto on the \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_.

HILLTOP HOLDINGS INC.

By: \_\_\_\_\_

Its \_\_\_\_\_

[OPTIONEE]

Signature: \_\_\_\_\_

Printed Name \_\_\_\_\_

Address: \_\_\_\_\_

6

---

[\(Back To Top\)](#)

## Section 4: EX-21.1 (EX-21.1)

Exhibit 21.1

### Hilltop Holdings Inc. List of Subsidiaries (Direct and Indirect)

Name	State or Other Jurisdiction of Incorporation or Formation
HTH Operating Partnership LP	Delaware
American Summit Insurance Company	Texas
ARC Insurance Holdings, Inc.	Delaware
Colonial Water Gardens, Inc.	Kansas
Enspire Insurance Services, Inc.	Delaware
Excalibur Financial Corporation	Delaware



Hilltop Investments I LLC	Delaware
JE Murphy Company, Inc.	Arizona
JE Murhpy Company of Florida, Inc.	Florida
NALICO General Agency, Inc.	Texas
NAGRUPCO, Ltd.	Texas
National Group Corporation	Delaware
National Lloyds Insurance Corporation	Texas
NLASCO National Lloyds, Inc.	Texas
NLASCO Underwriter Partner 1 LLC	Delaware
NLASCO Underwriter Partner 2 LLC	Delaware
NLASCO Underwriter Partnership	Delaware
NLASCO, Inc.	Delaware
NLASCO Services, Inc.	Texas

[\(Back To Top\)](#)

## Section 5: EX-23.1 (EX-23.1)

**Exhibit 23.1**

### CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statement on Form S-3 (Nos. 333-129254 and 333-160047) and Form S-8 (333-112874) of Hilltop Holdings Inc. of our report dated March 11, 2011 relating to the financial statements, financial statement schedules and the effectiveness of internal control over financial reporting, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

Dallas, Texas  
March 11, 2011

[\(Back To Top\)](#)

## Section 6: EX-31.1 (EX-31.1)

**Exhibit 31.1**

### **Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002**

I, Jeremy B. Ford, certify that:

1. I have reviewed this Annual Report on Form 10-K of Hilltop Holding Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about

the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

- (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 11, 2011

/s/ JEREMY B. FORD

---

Jeremy B. Ford  
Chief Executive Officer  
(principal executive officer)

---

[\(Back To Top\)](#)

## Section 7: EX-31.2 (EX-31.2)

Exhibit 31.2

### Certification Pursuant to Section 302 of Sarbanes-Oxley Act of 2002

I, Darren Parmenter, certify that:

1. I have reviewed this Annual Report on Form 10-K of Hilltop Holding Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are

reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 11, 2011

/s/ DARREN PARMENTER

Darren Parmenter  
Senior Vice President — Finance  
(principal financial officer)

---

[\(Back To Top\)](#)

## Section 8: EX-32.1 (EX-32.1)

Exhibit 32.1

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER**  
**Required by 18 U.S.C. Section 1350**  
**(as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)**

In connection with the Annual Report of Hilltop Holdings Inc. (the "Company") on Form 10-K for the period ended December 31, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Jeremy B. Ford, as principal executive officer of the Company, hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 11, 2011

/s/ JEREMY B. FORD

Jeremy B. Ford  
Chief Executive Officer

---

[\(Back To Top\)](#)

## Section 9: EX-32.2 (EX-32.2)

Exhibit 32.2

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER**  
**Required by 18 U.S.C. Section 1350**  
**(as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002)**

In connection with the Annual Report of Hilltop Holdings Inc. (the "Company") on Form 10-K for the period ended December 31, 2010, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Darren Parmenter, as principal financial officer of the Company, hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to his knowledge:

1. The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 11, 2011

/s/ DARREN PARMENTER

Darren Parmenter  
Senior Vice President - Finance

---

[\(Back To Top\)](#)

