

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

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

For the fiscal year ended December 31, 2008

OR

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

For the transition period from _____ to _____

Commission file number 0-15341

DONEGAL GROUP INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

1195 River Road, Marietta, Pennsylvania

(Address of principal executive offices)

23-2424711

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

17547

(Zip code)

Registrant's telephone number, including area code: (888) 877-0600

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

Title of Each Class

Name of Each Exchange on Which Registered

Class A Common Stock, \$.01 par value

The NASDAQ Global Select Market

Class B Common Stock, \$.01 par value

The NASDAQ Global Select Market

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

Indicate by check mark whether 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 15(d) of the Exchange 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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 capital reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company. Yes No .

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$197,694,116.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 19,884,500 shares of Class A common stock and 5,576,775 shares of Class B common stock outstanding on February 27, 2009.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the registrant's annual report to stockholders for the fiscal year ended December 31, 2008 are incorporated by reference into Parts I, II and IV of this report.
2. Portions of the registrant's proxy statement relating to registrant's annual meeting of stockholders to be held April 16, 2009 are incorporated by reference into Part III of this report.



DONEGAL GROUP INC.
INDEX TO FORM 10-K REPORT

	<u>Page</u>
<u>PART I</u>	
<u>Item 1. Business</u>	1
<u>Item 1A. Risk Factors</u>	33
<u>Item 1B. Unresolved Staff Comments</u>	45
<u>Item 2. Properties</u>	45
<u>Item 3. Legal Proceedings</u>	45
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	45
<u>Executive Officers of the Company</u>	46
<u>PART II</u>	
<u>Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	47
<u>Item 6. Selected Financial Data</u>	48
<u>Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	48
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	48
<u>Item 8. Financial Statements and Supplementary Data</u>	50
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	50
<u>Item 9A. Controls and Procedures</u>	50
<u>Item 9B. Other Information</u>	51
<u>PART III</u>	
<u>Item 10. Directors, Executive Officers and Corporate Governance of the Registrant</u>	52
<u>Item 11. Executive Compensation</u>	52
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	52
<u>Item 13. Certain Relationships and Related Transactions and Director Independence</u>	52
<u>Item 14. Principal Accountant Fees and Services</u>	52
<u>PART IV</u>	
<u>Item 15. Exhibits and Financial Statement Schedules</u>	53

PART I

Item 1. Business.

(a) General Development of Business.

We are an insurance holding company whose insurance subsidiaries offer personal and commercial lines of property and casualty insurance to businesses and individuals in 18 Mid-Atlantic, Midwestern and Southeastern states. Our insurance subsidiaries provide their policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At December 31, 2008, we had total assets of \$880.1 million and stockholders' equity of \$363.6 million. Our net income was \$25.5 million for the year ended December 31, 2008 compared to \$38.3 million for the year ended December 31, 2007.

Donegal Mutual Insurance Company ("Donegal Mutual") owns approximately 42.0% of our Class A common stock and approximately 74.5% of our Class B common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries have the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Our growth strategies include the acquisition of other insurance companies to expand our business in a given region or to commence operations in a new region. Our prior acquisitions have taken the form of either:

- a purchase of the stock of a stock insurance company; or
- a two-step acquisition of a mutual insurance company in which:
 - as the first step, Donegal Mutual purchases a surplus note from the mutual insurance company, Donegal Mutual enters into a management agreement with the mutual insurance company and Donegal Mutual's designees become a majority of the board of directors of the mutual insurance company.
 - as the second step, the mutual insurance company demutualizes, or converts, into a stock insurance company. Upon the conversion, we purchase the surplus note from Donegal Mutual and exchange it for all of the stock of the stock insurance company resulting from the conversion.

We believe that our ability to make direct acquisitions of stock insurance companies and to make indirect acquisitions of mutual insurance companies through a sponsored conversion provides us with flexibility that is a competitive advantage in seeking acquisitions. We also believe we have demonstrated our ability to acquire control of an underperforming insurance company, reunderwrite its book of business, reduce its cost structure and return it to profitability. When Donegal Mutual makes a surplus note investment in another company and enters into a management agreement with it, Donegal Mutual does not consolidate the financial results of that company with its financial results, and Donegal Mutual is not responsible for the insurance obligations of that company.

While Donegal Mutual and we generally engage in preliminary discussions with potential direct or indirect acquisition candidates on an almost continuous basis and are so engaged at the date of this Form 10-K Report, neither Donegal Mutual nor we make any public disclosure regarding an acquisition until Donegal Mutual or we have entered into a definitive acquisition agreement.

We completed the acquisition of Sheboygan Falls Insurance Company (“Sheboygan”) on December 1, 2008. As part of the acquisition, we purchased the \$3.5 million contribution note of Sheboygan Falls Mutual Insurance Company from Donegal Mutual for \$3.5 million in cash. Simultaneously, we then converted the contribution note into all of the outstanding stock of Sheboygan. We also made an additional contribution to Sheboygan of \$8.5 million in cash.

(b) Financial Information About Industry Segments.

Our insurance subsidiaries have three segments: investments, personal lines of insurance and commercial lines of insurance. Financial information about these segments is set forth in Note 20 to our consolidated financial statements incorporated by reference in this Form 10-K Report.

(c) Narrative Description of Business.

Who We Are

We are an insurance holding company whose insurance subsidiaries offer personal and commercial lines of property and casualty insurance to small businesses and individuals in 18 Mid-Atlantic, Midwestern and Southeastern states. Our insurance subsidiaries provide their policyholders with a selection of insurance products at competitive rates, while pursuing profitability by adhering to a strict underwriting discipline.

Our insurance subsidiaries derive a substantial portion of their insurance business from smaller to mid-sized regional communities. We believe this focus provides our insurance subsidiaries with competitive advantages in terms of local market knowledge,

marketing, underwriting, claims servicing and policyholder service. At the same time, we believe our insurance subsidiaries have cost advantages over many smaller regional insurers because of the centralized accounting, administrative, data processing, investment and other services available to our insurance subsidiaries on a cost-effective basis because of economies of scale.

Strategy

The annual net premiums our insurance subsidiaries earn have increased from \$196.8 million in 2003 to \$346.6 million in 2008, a compound annual growth rate of 12%. Over the same time period, our insurance subsidiaries have achieved a combined ratio consistently more favorable than that of the property and casualty insurance industry as a whole. Our insurance subsidiaries seek to increase their annual net premiums earned and enhance their profitability by:

- *Achieving underwriting profitability.*

Our insurance subsidiaries focus on achieving a combined ratio of less than 100%. We believe that underwriting profitability is a fundamental component of our long-term financial strength because it allows our insurance subsidiaries to generate profits without relying on their investment income. Our insurance subsidiaries seek to enhance their underwriting results by:

- carefully selecting the product lines they underwrite;
- minimizing their exposure to catastrophe-prone areas; and
- evaluating their claims history on a regular basis to ensure the adequacy of their underwriting guidelines and product pricing.

Our insurance subsidiaries have no material exposures to asbestos and environmental liabilities. Our insurance subsidiaries seek to provide more than one policy to a given personal or commercial customer because this “account selling” strategy diversifies their risk and has historically improved their underwriting results. Finally, our insurance subsidiaries use reinsurance to manage their exposure and limit their maximum net loss from large single risks or risks in concentrated areas. Our insurance subsidiaries believe these practices are key factors in their ability to maintain a combined ratio that has been traditionally more favorable than the combined ratio of the property and casualty insurance industry.

The combined ratio of our insurance subsidiaries and that of the property and casualty insurance industry for the years 2004 through 2008 are shown in the following table:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Our GAAP combined ratio	93.1%	89.5%	89.0%	91.3%	97.2%
Industry SAP combined ratio ⁽¹⁾	98.5	101.2	92.4	95.6	104.7

(1) As reported or projected by A.M. Best.

- *Pursuing profitable growth by organic expansion within the traditional operating territories of our insurance subsidiaries through developing and maintaining quality agency representation.*

We believe that continued expansion of our insurance subsidiaries within their existing markets will be a key source of their continued premium growth and that maintaining an effective and growing network of independent agencies is integral to their expansion. Our insurance subsidiaries seek to be among the top three insurers within each of the independent agencies for the lines of business they write by providing a consistent, competitive and stable market for their products. We believe that the consistency of their product offerings enables our insurance subsidiaries to compete effectively for agents with other insurers whose product offerings fluctuate based on industry conditions. Our insurance subsidiaries offer a competitive compensation program to their independent agents that rewards them for pursuing profitable growth for our insurance subsidiaries. Our insurance subsidiaries provide their independent agents with ongoing support to enable them to better attract and service customers, including:

- fully automated underwriting and policy issuance systems for both personal and commercial lines;
- training programs;
- marketing support; and
- field visitations by marketing personnel and senior management of our insurance subsidiaries.

Finally, our insurance subsidiaries appoint independent agencies with a strong underwriting and growth track record. We believe that our insurance subsidiaries, by carefully selecting, motivating and supporting their independent agency force, will be able to drive continued long-term growth.

- *Acquiring property and casualty insurance companies to augment the organic growth of our insurance subsidiaries in existing markets and to expand into new geographic regions.*

We have completed five acquisitions of property and casualty insurance companies since 1995. We intend to continue our growth by pursuing affiliations and acquisitions that meet our criteria. Our criteria include:

- Location in regions where our insurance subsidiaries are currently conducting business or that offer an attractive opportunity to conduct profitable business;
- A mix of business similar to the mix of business of our insurance subsidiaries;
- Premium volume between \$20.0 million and \$100.0 million; and
- Fair and reasonable transaction terms.

We believe that our interrelationship with Donegal Mutual assists us in pursuing affiliations with and subsequent acquisitions of mutual insurance companies because, through Donegal Mutual, we understand the concerns and issues that mutual insurance companies face. In particular, we have had success affiliating with and acquiring underperforming mutual insurance companies by utilizing our strengths and financial position to improve their operations significantly. We evaluate a number of areas for operational synergies when considering acquisitions, including product underwriting, expenses, the cost of reinsurance and technology.

- *Focusing on expense controls and utilization of technology to increase the operating efficiency of our insurance subsidiaries.*

Our insurance subsidiaries maintain stringent expense controls under direct supervision of their senior management. We centralize many processing and administrative activities of our insurance subsidiaries to realize operating synergies and better control expenses. Our insurance subsidiaries utilize technology to automate much of their underwriting and to facilitate agency and policyholder communications on an efficient and cost-effective basis. We operate on a paperless basis. As a result of our focus on expense control, our insurance subsidiaries have reduced their expense ratio from 36.6% in 1999 to 32.1% in 2008. Our insurance subsidiaries have also increased their annual premium per employee, a measure of efficiency that our insurance subsidiaries use to evaluate their operations, from approximately \$470,000 in 1999 to approximately \$793,000 in 2008.

Our insurance subsidiaries maintain technology comparable to that of the largest of their competitors. "Ease of doing business" is an increasingly important component of an insurer's value to an independent agency. Our insurance subsidiaries provide a fully automated personal lines underwriting and policy issuance system called "WritePro®." WritePro® is a web-based user interface that substantially eases data entry and facilitates the quoting and issuance of policies for our independent agents. Our insurance subsidiaries also

provide a similar commercial business system called “WriteBiz®.” WriteBiz® is a web-based interface that provides the independent agents of our insurance subsidiaries with an online ability to quote and issue commercial automobile, workers’ compensation, businessowners and tradesman policies automatically. As a result, applications of the independent agents for our insurance subsidiaries can become policies without further re-entry of information. Both systems download the policy information to the policy management systems of the independent agents of our insurance subsidiaries.

- *Providing responsive and friendly customer and agent service to enable our insurance subsidiaries to attract new policyholders and retain existing policyholders.*

We believe that excellent policyholder service is important in attracting new policyholders and retaining existing policyholders. Our insurance subsidiaries work closely with their independent agents to provide a consistently responsive level of claims service, underwriting and customer support. Our insurance subsidiaries seek to respond expeditiously and effectively to address customer and independent agent inquiries, including:

- Quick replies to information requests and policy submissions; and
- Prompt responses to and processing of claims.

Our insurance subsidiaries periodically conduct policyholder surveys to evaluate the effectiveness of their service to policyholders. The management of our insurance subsidiaries meets frequently with the personnel of the independent insurance agents our insurance subsidiaries appoint to seek service improvement recommendations, react to service issues and better understand local market conditions.

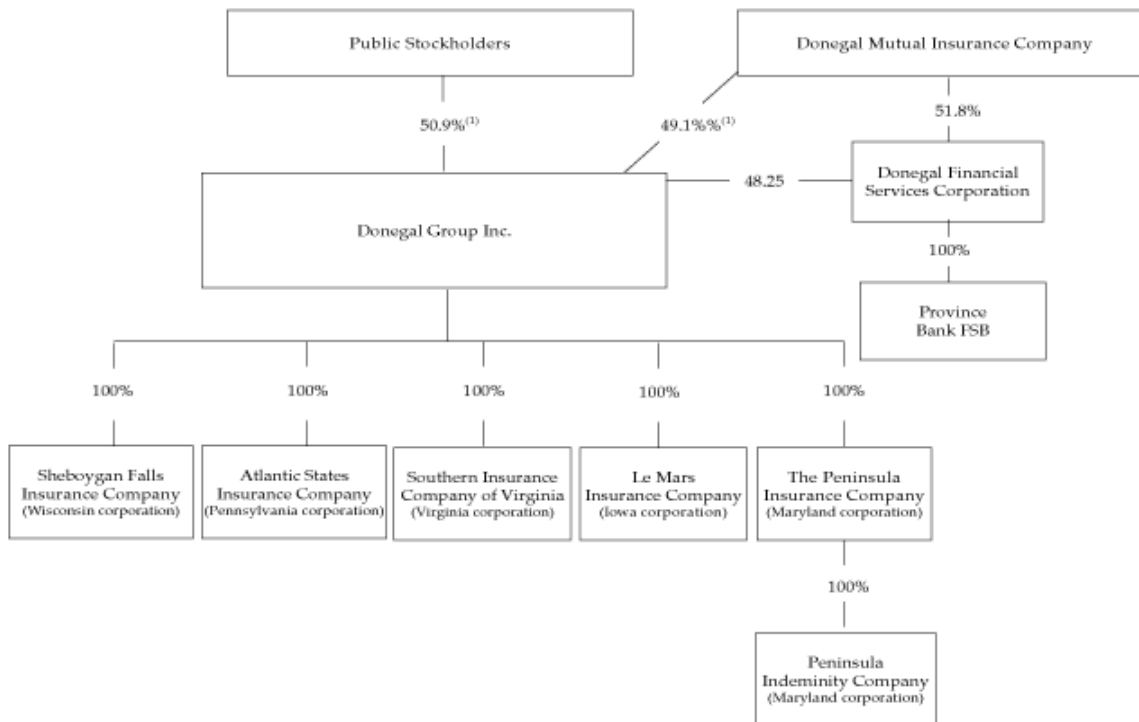
- *Maintaining premium rate adequacy to enhance the underwriting results of our insurance subsidiaries, while maintaining their existing book of business and preserving their ability to write new business.*

Our insurance subsidiaries seek discipline in their pricing by effecting rate increases to maintain or improve their underwriting profitability without unduly affecting their customer retention. In addition to appropriate pricing, our insurance subsidiaries seek to ensure that their premium rates are adequate relative to their level of underwriting risk. Our insurance subsidiaries review loss trends on a periodic basis to identify changes in the frequency and severity of their claims and to assess the adequacy of their rates and underwriting standards. Our insurance subsidiaries also carefully monitor and audit the information they use to price their policies, enabling them to receive an adequate level of premiums for their risk. For example, our insurance subsidiaries inspect and perform loss control surveys on most of the risks they insure to determine the adequacy of the insured amount to the value of the insured property, assess property conditions and identify any liability exposures. Our insurance

subsidiaries audit the payroll data of their workers' compensation customers to verify that the assumptions used to price a particular policy were accurate. By implementing appropriate rate increases and understanding the risks our insurance subsidiaries insure, they are able to achieve their strategy of achieving consistent underwriting profitability.

Our Organizational Structure

We have six insurance subsidiaries: Atlantic States Insurance Company (“Atlantic States”), Southern Insurance Company of Virginia (“Southern”), Le Mars Insurance Company (“Le Mars”), Peninsula Insurance Group, which consists of The Peninsula Insurance Company and its wholly owned subsidiary, Peninsula Indemnity Company (collectively, the “Peninsula Companies”) and Sheboygan. We also own 48.2% of Donegal Financial Services Corporation (“DFSC”), a registered savings and loan holding company that owns Province Bank FSB, or Province Bank, a federal savings bank that began operations in 2000. Donegal Mutual owns the remaining 51.8% of DFSC. While not material to our operations, we believe Province Bank, with total assets of \$94.0 million at December 31, 2008, complements the product offerings of our insurance subsidiaries. The following chart summarizes our organizational structure and includes all of our property and casualty insurance subsidiaries:



(1) Because of the different relative voting power of our Class A common stock and our Class B common stock, our public stockholders hold approximately 34.1% of the aggregate voting power of our Class A

common stock and Class B common stock and Donegal Mutual holds approximately 65.9% of the aggregate voting power of our Class A common stock and Class B common stock.

In the mid-1980s, Donegal Mutual, like a number of other mutual property and casualty insurance companies, recognized the need to develop additional sources of capital and surplus to remain competitive and to have the capacity to expand its business and assure its long-term viability. Donegal Mutual, again like a number of other mutual property and casualty insurance companies, determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company, initially wholly owned by Donegal Mutual, and caused us to form an insurance company subsidiary known as Atlantic States.

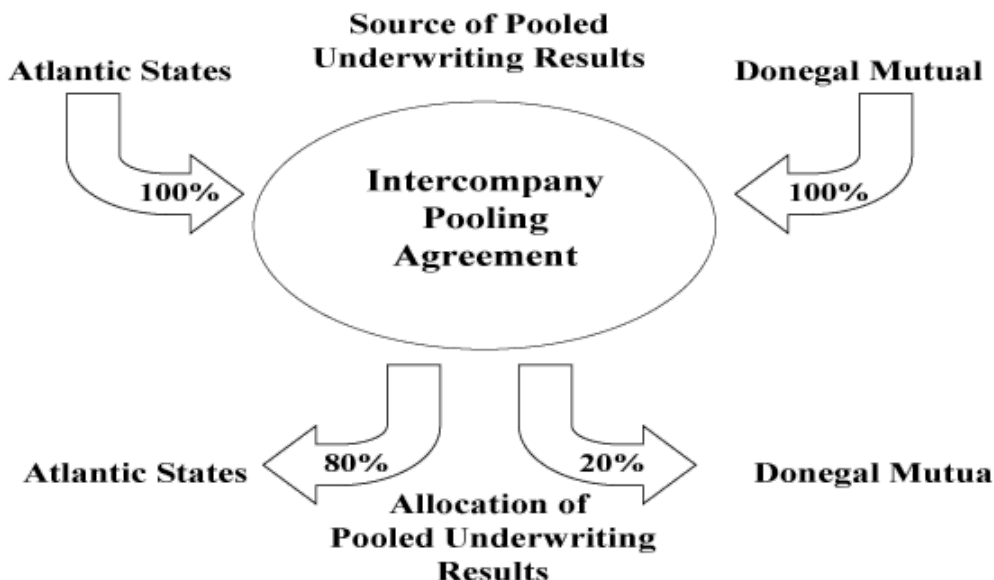
As part of the implementation of this strategy, Donegal Mutual and Atlantic States entered into a pooling agreement in 1986. Under the pooling agreement, Donegal Mutual and Atlantic States established an underwriting pool and each company cedes substantially all of its respective premiums, losses and expenses. Each company then receives an allocation of the pooled business from the underwriting pool. The consideration to Donegal Mutual for entering into the pooling agreement was its ownership of majority control of us and the expectation that Donegal Mutual's surplus would increase over time as the value of its ownership interest in us increased.

Since 1986, we have effected three public offerings, a major purpose of which has been to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As the capital of Atlantic States has increased, its underwriting capacity has increased proportionately. Thus, as originally planned in the mid-1980s, Atlantic States has had the capital necessary to support the growth of its direct business as well as increases in the amount and percentage of business Atlantic States assumes from the underwriting pool. As a result, the participation of Atlantic States in the underwriting pool has increased over the years from an initial participation of 35% in 1986 to an 80% participation since March 1, 2008, and the size of the underwriting pool has increased substantially. We do not anticipate any further changes in the pooling agreement between Atlantic States and Donegal Mutual in the foreseeable future, including any change in the percentage participation of Atlantic States in the underwriting pool.

Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, Donegal Mutual and our insurance subsidiaries conduct their insurance business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries have the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

The risk profiles of the business our insurance subsidiaries and Donegal Mutual write have historically been, and continue to be, substantially similar. The same management and underwriting personnel determine and administer the products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries. In addition, Donegal Mutual and our insurance subsidiaries share a business plan to achieve market penetration and underwriting profitability objectives. The products Donegal Mutual and our insurance subsidiaries offer are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier compared to standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business directly written by each of the companies will vary. However, the underwriting pool homogenizes the risk characteristics of all business written directly by Donegal Mutual and Atlantic States, and each of Donegal Mutual and Atlantic States shares the underwriting results in proportion to its participation in the pool. Since March 1, 2008, we realize 80% of the underwriting results of the underwriting pool because of the 80% participation of Atlantic States in the underwriting pool. The revenues Atlantic States derives from the underwriting pool represent the predominant percentage of its total revenues.

The following chart depicts the underwriting pool as effective since March 1, 2008:



Donegal Mutual provides facilities, personnel and other services to us and six of our insurance subsidiaries, Atlantic States, Southern, Le Mars, the Peninsula Companies and Sheboygan. Donegal Mutual allocates expenses to Southern, Le Mars and the Peninsula Companies according to a time allocation and estimated usage agreement and to Atlantic States in relation to the relative participation of Donegal Mutual and Atlantic States in the underwriting pool. Southern, Le Mars and the Peninsula Companies reimburse Donegal Mutual for their personnel costs, and Southern, Peninsula and Sheboygan bear their proportionate share of information services costs based on their percentage of total written premiums of the Donegal Insurance Group. Donegal Mutual allocated expenses to us and our insurance subsidiaries under such agreements of \$56.8 million, \$52.3 million and \$48.8 million in 2008, 2007 and 2006, respectively.

We and Donegal Mutual have maintained a coordinating committee since our formation in 1986. The coordinating committee consists of two members of our board of directors who are not also members of Donegal Mutual's board of directors and two members of Donegal Mutual's board of directors who are not also members of our board of directors.

Under our by-laws and the by-laws of Donegal Mutual, any new agreement between Donegal Mutual and us and any proposed change to an existing agreement between Donegal Mutual and us is first submitted for approval to the coordinating committee. In determining whether to approve a new agreement or a change in an existing agreement between Donegal Mutual and us, our members of the coordinating committee will not approve the new

agreement or the change in an existing agreement between Donegal Mutual and us unless both of our members believe that the new agreement or the change in an existing agreement between Donegal Mutual and us is fair and equitable to us and in the best interests of our stockholders. Donegal Mutual's members of the coordinating committee will not approve the new agreement or the change in the existing agreement between Donegal Mutual and us unless both members believe that the new agreement or change in an existing agreement between Donegal Mutual and us is fair and equitable to Donegal Mutual and in the best interests of its policyholders. If the coordinating committee unanimously approves the new agreement or change in an existing agreement between Donegal Mutual and us, we then submit the new agreement or the change in an existing agreement between Donegal Mutual and us to our board of directors and the board of directors of Donegal Mutual for their separate consideration. The new agreement or the change in an existing agreement between Donegal Mutual and us will become effective only if the coordinating committee, our board of directors and Donegal Mutual's board of directors all approve the new agreement or the change in an existing agreement between Donegal Mutual and us.

The coordinating committee also meets annually to review each existing agreement between Donegal Mutual and us and our insurance subsidiaries to determine if the terms of the existing agreements remain fair and equitable to us and in the best interests of our stockholders and remain fair and equitable to Donegal Mutual and in the best interests of its policyholders or if adjustments should be made. These agreements are ongoing in nature and will continue in effect throughout 2009 in the ordinary course of business.

Our members on the coordinating committee are Robert S. Bolinger and John J. Lyons. Donegal Mutual's members on the coordinating committee are John E. Hiestand and Frederick W. Dreher. Reference is made to our proxy statement for our annual meeting of stockholders on April 16, 2009 for information on the members of the coordinating committee.

We believe our relationship with Donegal Mutual offers us and our insurance subsidiaries a number of competitive advantages, including the following:

- Facilitating the stable management, consistent underwriting discipline, external growth and long-term profitability of our insurance subsidiaries;
- Creating operational and expense synergies given the combined resources and operating efficiencies of Donegal Mutual, us and our insurance subsidiaries;
- Enhancing our opportunities to expand by acquisition because of the ability of Donegal Mutual to acquire control of other mutual insurance companies and thereafter sponsor the demutualization or conversion of the mutual insurance company into a stock insurance company that we can then purchase from Donegal Mutual;

- Producing a more uniform and stable underwriting result than our insurance subsidiaries could achieve without the relationship between Donegal Mutual and our insurance subsidiaries over extended periods of time; and
- Providing Atlantic States with a significantly larger underwriting capacity because of the underwriting pool Donegal Mutual and Atlantic States have maintained since 1986.

Acquisitions

The following table highlights our acquisition history since 1988:

<u>Company Acquired</u>	<u>State of Domicile</u>	<u>Year Control Acquired(2)</u>	<u>Method of Acquisition</u>
Southern Mutual Insurance Company and now Southern Insurance Company of Virginia	Virginia	1984	Surplus note investment by Donegal Mutual in 1984; demutualization in 1988; acquisition of stock by us in 1988.
Pioneer Mutual Insurance Company and formerly Pioneer Insurance Company (1)	Ohio	1992	Surplus note investment by Donegal Mutual in 1992; demutualization in 1993; acquisition of stock by us in 1997.
Delaware Mutual Insurance Company and formerly Delaware Atlantic Insurance Company (1)	Delaware	1993	Surplus note investment by Donegal Mutual in 1993; demutualization in 1994; acquisition of stock by us in 1995.
Pioneer Mutual Insurance Company and formerly Pioneer Insurance Company (1)	New York	1995	Surplus note investment by Donegal Mutual in 1995; demutualization in 1998; acquisition of stock by us in 2001.
Southern Heritage Insurance Company (1)	Georgia	1998	Purchase of stock by us in 1998.

<u>Company Acquired</u>	<u>State of Domicile</u>	<u>Year Control Acquired(2)</u>	<u>Method of Acquisition</u>
Le Mars Mutual Insurance Company of Iowa and now Le Mars Insurance Company	Iowa	2002	Surplus note investment by Donegal Mutual in 2002; demutualization in 2004; acquisition of stock by us in 2004.
Peninsula Insurance Group	Maryland	2004	Purchase of stock by us in 2004.
Sheboygan Falls Mutual Insurance Company and now Sheboygan Falls Insurance Company	Wisconsin	2007	Contribution note investment by Donegal Mutual in 2007; demutualization in 2008; acquisition of stock by us in 2008.

- (1) To reduce administrative and compliance costs and expenses, these subsidiaries subsequently merged into one of our existing insurance subsidiaries.
- (2) Control acquired by Donegal Mutual or us.

We generally maintain the home office of an acquired company as part of our strategy to provide local marketing, underwriting and claims servicing even if we merge the acquired company into another subsidiary.

Distribution

Our insurance subsidiaries market their products primarily in the Mid-Atlantic, Midwest and Southeast regions through approximately 2,000 independent insurance agencies. At December 31, 2008, the Donegal Insurance Group was actively writing business in 18 states (Alabama, Delaware, Georgia, Iowa, Maryland, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia, West Virginia and Wisconsin). We believe the relationships of our insurance subsidiaries with their independent agents are valuable in identifying, obtaining and retaining profitable business. Our insurance subsidiaries maintain a stringent agency selection procedure that emphasizes appointing agencies with proven marketing strategies for the development of profitable business, and our insurance subsidiaries only appoint agencies with a strong underwriting and growth track record. Our insurance subsidiaries also regularly evaluate the independent agencies that represent them based on their profitability and performance in relation to the objectives of our insurance subsidiaries. Our

insurance subsidiaries seek to be among the top three insurers within each of their agencies for the lines of business they write.

The following table sets forth the percentage of direct premiums written by our insurance subsidiaries in each of the states where they conducted a significant portion of their business in 2008:

Pennsylvania	48.8%
Maryland	11.1
Virginia	10.8
Georgia	6.3
Delaware	6.1
Ohio	3.5
Iowa	2.5
Wisconsin	2.1
North Carolina	1.9
Tennessee	1.9
Oklahoma	1.2
Nebraska	1.1
South Dakota	1.1
Other	1.6
Total	<u>100.0%</u>

We believe our insurance subsidiaries employ a number of policies and procedures that enable them to attract, retain and motivate their independent agents. The consistency, competitiveness and stability of the product offerings of our insurance subsidiaries assist them in competing effectively for independent agents with other insurers whose product offerings may fluctuate based upon industry conditions. Our insurance subsidiaries have a competitive contingent commission plan for their independent agents, under which the independent agents may earn additional commissions based upon the volume of premiums produced and the profitability of the business our insurance subsidiaries receive from that agency. Our insurance subsidiaries provide their independent agents ongoing support that better enables the agents to attract and retain customers, including:

- fully automated underwriting and policy issuance systems for both personal and commercial lines;
- training programs;
- marketing support; and
- field visitations from marketing personnel and senior management of our insurance subsidiaries.

Finally, our insurance subsidiaries encourage their independent agents to focus on “account selling,” or serving all of a particular insured’s property and casualty insurance needs, which our insurance subsidiaries believe generally results in more favorable loss experience than covering a single risk for an individual insured.

Products

The personal lines our insurance subsidiaries write consist primarily of private passenger automobile and homeowners insurance. The commercial lines our insurance subsidiaries write consist primarily of commercial automobile, commercial multi-peril and workers’ compensation insurance. We describe these types of insurance in greater detail below:

Personal

- Private passenger automobile — policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.
- Homeowners — policies that provide coverage for damage to residences and their contents from a broad range of perils, including fire, lightning, windstorm and theft. These policies also cover liability of the insured arising from injury to other persons or their property while on the insured’s property and under other specified conditions.

Commercial

- Commercial automobile — policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and protection against loss from damage to automobiles owned by the insured.
- Commercial multi-peril — policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.
- Workers’ compensation — policies employers purchase to provide benefits to employees for injuries sustained during employment. The workers’ compensation laws of each state determine the extent of the coverage we provide.

The following table sets forth the net premiums written by line of insurance by our insurance subsidiaries for the periods indicated:

(dollars in thousands)	Year Ended December 31,					
	2006		2007		2008	
	Amount	%	Amount	%	Amount	%
Net Premiums Written:						
Personal lines:						
Automobile	\$ 126,211	41.1%	\$ 132,452	42.2%	\$ 154,091	42.2%
Homeowners	56,005	18.2	58,602	18.7	72,195	19.8
Other	10,764	3.5	11,299	3.6	13,254	3.6
Total personal lines	<u>\$ 192,980</u>	<u>62.8</u>	<u>\$ 202,353</u>	<u>64.5</u>	<u>\$ 239,540</u>	<u>65.6</u>
Commercial lines:						
Automobile	33,387	10.9	32,059	10.2	\$ 35,959	9.9
Workers' compensation	32,845	10.7	32,361	10.3	36,459	10.0
Commercial multi-peril	44,750	14.6	43,559	13.9	49,004	13.4
Other	3,445	1.0	3,357	1.1	3,979	1.1
Total commercial lines	<u>\$ 114,427</u>	<u>37.2</u>	<u>\$ 111,336</u>	<u>35.5</u>	<u>\$ 125,401</u>	<u>34.4</u>
Total business	<u>\$ 307,407</u>	<u>100.0%</u>	<u>\$ 313,689</u>	<u>100.0%</u>	<u>\$ 364,941</u>	<u>100.0%</u>

Underwriting

The personal lines and commercial lines underwriting departments of our insurance subsidiaries evaluate and select those risks that they believe will enable our insurance subsidiaries to achieve an underwriting profit. The underwriting departments have significant interaction with the independent agents regarding the underwriting philosophy and underwriting guidelines of our insurance subsidiaries and assist the research and development department in the development of quality products at competitive prices to promote growth and profitability.

In order to achieve underwriting profitability on a consistent basis, our insurance subsidiaries:

- assess and select quality standard and preferred risks;
- adhere to disciplined underwriting and reunderwriting guidelines;
- inspect substantially all commercial lines risks and a substantial number of personal lines risks; and
- utilize various types of risk management and loss control services.

Our insurance subsidiaries also review their existing policies and accounts to determine whether those risks continue to meet their underwriting guidelines. If a given policy or account no longer meets those underwriting guidelines, our insurance subsidiaries will take appropriate action regarding that policy or account, including raising premium rates or non-renewing the policy to the extent permitted by applicable law.

As part of the effort of our insurance subsidiaries to maintain acceptable underwriting results, they conduct annual reviews of agencies that have failed to meet their underwriting profitability criteria. The review process includes an analysis of the underwriting and reunderwriting practices of the agency, the completeness and accuracy of the applications submitted by the agency, the adequacy of the training of the agency's staff and the agency's record of adherence to the underwriting guidelines and service standards of our insurance subsidiaries. Based on the results of this review process, the marketing and underwriting personnel of our insurance subsidiaries develop, together with the agency, a plan to improve its underwriting profitability. Our insurance subsidiaries monitor the agency's compliance with the plan, and take other measures as required in the judgment of our insurance subsidiaries, including the termination of agencies that are unable to achieve acceptable underwriting profitability to the extent permitted by applicable law.

Claims

The management of claims is a critical component of the philosophy of our insurance subsidiaries to achieve underwriting profitability on a consistent basis and is fundamental to the successful operations of our insurance subsidiaries and their dedication to excellent service.

The claims departments of our insurance subsidiaries rigorously manage claims to assure that they settle legitimate claims quickly and fairly and that they identify questionable claims for defense. In the majority of cases, the personnel of our insurance subsidiaries, who have significant experience in the property and casualty insurance industry and know the service philosophy of our insurance subsidiaries, adjust claims. Our insurance subsidiaries provide various means of claims reporting on a 24-hour, seven-day a week basis, including toll-free numbers and electronic reporting through our website. Our insurance subsidiaries strive to respond to notifications of claims promptly, generally within the day reported. Our insurance subsidiaries believe that by responding promptly to claims, they provide quality customer service and minimize the ultimate cost of the claims. Our insurance subsidiaries engage independent adjusters as needed to handle claims in areas in which the volume of claims is not sufficient to justify the hiring of internal claims adjusters. Our insurance subsidiaries also employ private investigators, structural experts and various outside legal counsel to supplement our in-house staff and to assist in the investigation of claims. Our insurance subsidiaries have a special investigative unit staffed by former law enforcement officers that attempts to identify and prevent fraud and abuse and to control questionable claims.

The management of the claims departments of our insurance subsidiaries develops and implements policies and procedures for the establishment of adequate claim reserves. Our insurance subsidiaries employ an actuarial staff that regularly reviews their reserves for incurred but not reported claims. The management and staff of the claims departments

resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. The litigation and personal injury sections of our insurance subsidiaries manage all claims litigation, and branch office claims above certain thresholds require home office review and settlement authorization. Our insurance subsidiaries provide their claims adjusters reserving and settlement authority based upon their experience and demonstrated abilities. Larger or more complicated claims require consultation and approval of senior department management.

The field office staff of our insurance subsidiaries receives support from home office technical, litigation, material damage, subrogation and medical audit personnel.

Liabilities for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. An insurer recognizes at the time of establishing its estimates that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our insurance subsidiaries base their estimates of liabilities for losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and, consequently, it often becomes necessary to refine and adjust their prior estimates of their liabilities. Our insurance subsidiaries reflect any adjustments to their liabilities for losses and loss expenses in their operating results in the period in which they effect a change in their estimates.

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. Our insurance subsidiaries base the amount of liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

Reserve estimates can change over time because of unexpected changes in assumptions related to the external business environment and, to a lesser extent, assumptions as to the internal operations of our insurance subsidiaries. For example, our insurance

subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to the external business environment include the absence of significant changes in tort law and legal decisions that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business. To the extent our insurance subsidiaries determine that underlying factors impacting these assumptions have changed, they attempt to make appropriate adjustments for such changes in their reserves. Accordingly, the ultimate liability for unpaid losses and loss expenses of our insurance subsidiaries will likely differ from the amount recorded at December 31, 2008. For every 1% change in the loss and loss expense reserves estimates of our insurance subsidiaries, net of reinsurance recoverable, the effect on the pre-tax results of operations of our insurance subsidiaries would be approximately \$1.6 million.

The establishment of appropriate liabilities is an inherently uncertain process, and the ultimate liability of our insurance subsidiaries could exceed their loss and loss expense reserves and have an adverse effect on their results of operations and financial condition. Furthermore, our insurance subsidiaries cannot predict the timing, frequency and extent of adjustments to their estimated future liabilities because the historical conditions and events that serve as a basis for the estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and, in other periods, their estimates have exceeded their actual liabilities. Changes in estimates of the liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$2.7 million, (\$10.0) million and (\$13.6) million in 2008, 2007 and 2006, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and there have been no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in those years. The majority of the 2008 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2008 development represented 1.2% of the December 31, 2007 carried reserves and was primarily driven by higher-than-expected severity in the private passenger automobile liability line of business in accident year 2007. We recognized favorable development in 2007 and 2006 related primarily to the private passenger automobile liability, workers' compensation, commercial automobile liability and commercial

multi-peril lines of business. Generally, our insurance subsidiaries experienced improving loss development trends during these years attributable to favorable settlements of previously-reported claims by our insurance subsidiaries. Our insurance subsidiaries have implemented advances in automation and added personnel in the past three years to enhance their claims servicing ability. These enhancements have resulted in shorter claim life cycles and more timely settlement of claims, thereby contributing to loss development trends experienced in these periods.

Excluding the impact of isolated catastrophic weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. Further adjustments to insurance subsidiaries' estimates could be required in the future. However, on the basis of our insurance subsidiaries internal procedures which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries have a combined business plan to achieve market penetration and underwriting profitability objectives. The products offered by Donegal Mutual and our insurance subsidiaries are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to the specific risk profiles targeted within similar classes of business, such as preferred tier products compared to standard tier products, but we do not allocate all of the standard risk gradients to one of the companies. Therefore, the underwriting profitability of the business directly written by each of Donegal Mutual and Atlantic States will vary. However, the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the underwriting pool, and each of Donegal Mutual and Atlantic States shares the underwriting results in proportion to its participation in the underwriting pool. We realize 80% of the underwriting profitability of the underwriting pool because of the 80% participation of Atlantic States in the underwriting pool. The business Atlantic States derives from the underwriting pool represents a predominant percentage of our total revenues.

Differences between liabilities reported in our financial statements prepared on the basis of generally accepted accounting principles (“GAAP”) and our insurance subsidiaries’ financial statements prepared on a statutory accounting basis (“SAP”) result from anticipating salvage and subrogation recoveries for GAAP but not for SAP. These differences amounted to \$8.1 million, \$8.3 million and \$8.7 million at December 31, 2006, 2007 and 2008, respectively.

The following table sets forth a reconciliation of the beginning and ending GAAP net liability of our insurance subsidiaries for unpaid losses and loss expenses for the periods indicated:

(in thousands)	Year Ended December 31,		
	2006	2007	2008
Gross liability for unpaid losses and loss expenses at beginning of year	\$ 265,730	\$ 259,022	\$ 226,432
Less reinsurance recoverable	92,721	95,710	76,280
Net liability for unpaid losses and loss expenses at beginning of year	173,009	163,312	150,152
Acquisition of Sheboygan	—	—	2,173
Provision for net losses and loss expenses for claims incurred in the current year	182,037	187,797	221,617
Change in provision for estimated net losses and loss expenses for claims incurred in prior years	(13,616)	(10,013)	2,684
Total incurred	168,421	177,784	224,301
Net losses and loss payments for claims incurred during:			
The current year	106,401	118,444	143,369
Prior years	71,717	72,500	71,950
Total paid	178,118	190,944	215,319
Net liability for unpaid losses and loss expenses at end of year	163,312	150,152	161,307
Plus reinsurance recoverable	95,710	76,280	78,502
Gross liability for unpaid losses and loss expenses at end of year	\$ 259,022	\$ 226,432	\$ 239,809

The following table sets forth the development of the liability for net unpaid losses and loss expenses of our insurance subsidiaries from 1998 to 2008. Loss data in the table includes business ceded to Atlantic States from the underwriting pool.

“Net liability at end of year for unpaid losses and loss expenses” sets forth the estimated liability for net unpaid losses and loss expenses recorded at the balance sheet date for each of the indicated years. This liability represents the estimated amount of net losses and loss expenses for claims arising in the current and all prior years that are unpaid at the balance sheet date, including losses incurred but not reported.

The “Net liability reestimated as of” portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate increases or decreases as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 2004 liability has developed a redundancy after four years because the reestimated net losses and loss expenses are expected to be \$24.2 million less than the estimated liability initially established in 2004 of \$171.4 million.

The “Cumulative (excess) deficiency” shows the cumulative excess or deficiency at December 31, 2008 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or our insurance subsidiaries reevaluated the liability at less than the original estimate. A deficiency in liability means that the liability established in prior years was less than actual net losses and loss expenses or our insurance subsidiaries reevaluated the liability at more than the original estimate.

The “Cumulative amount of liability paid through” portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 2004 column indicates that as of December 31, 2008 payments equal to \$133.8 million of the currently reestimated ultimate liability for net losses and loss expenses of \$147.3 million had been made.

Amounts shown in the 2004 column of the table include information for Le Mars and the Peninsula Companies for all accident years prior to 2004.

(in thousands)	Year Ended December 31,										
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Net liability at end of year for unpaid losses and loss expenses	\$ 96,015	\$ 99,234	\$ 102,709	\$ 114,544	\$ 131,108	\$ 138,896	\$ 171,431	\$ 173,009	\$ 163,312	150,152	161,307
Net liability reestimated as of:											
One year later	95,556	100,076	110,744	121,378	130,658	136,434	162,049	159,393	153,299	152,836	
Two years later	95,315	103,943	112,140	120,548	128,562	130,030	152,292	153,894	150,934		
Three years later	94,830	104,073	110,673	118,263	124,707	123,399	148,612	151,792			
Four years later	94,354	101,880	108,766	114,885	119,817	120,917	147,280				
Five years later	93,258	100,715	107,561	113,070	118,445	119,968					
Six years later	92,818	100,479	106,950	112,614	118,605						
Seven years later	92,400	99,968	106,298	112,921							
Eight years later	92,064	99,927	106,835								
Nine years later	92,001	100,223									
Ten years later	92,211										
Cumulative (excess) deficiency	\$ (3,804)	989	4,126	(1,623)	(12,503)	(18,928)	(24,151)	(21,217)	(12,378)	2,684	
Cumulative amount of liability paid through:											
One year later	\$ 37,427	\$ 39,060	\$ 43,053	\$ 45,048	\$ 46,268	\$ 51,965	\$ 67,229	\$ 71,718	72,499	71,950	
Two years later	57,347	60,622	67,689	70,077	74,693	81,183	102,658	107,599	104,890		
Three years later	69,973	76,811	82,268	87,198	93,288	99,910	123,236	125,926			
Four years later	78,757	85,453	92,127	97,450	105,143	109,964	133,844				
Five years later	83,038	91,337	98,007	104,551	111,523	113,684					
Six years later	85,935	94,420	101,664	108,136	114,145						
Seven years later	87,600	96,823	103,767	110,193							
Eight years later	89,320	98,268	105,046								
Nine years later	90,301	98,847									
Ten years later	90,576										

	Year Ended December 31									
	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Gross liability at end of year	\$ 156,476	\$ 179,840	\$ 210,692	\$ 217,914	\$ 267,190	\$ 265,730	\$ 259,022	226,432	239,809	
Reinsurance recoverable	53,767	65,296	79,584	79,018	95,759	92,721	95,710	76,280	78,502	
Net liability at end of year	102,709	114,544	131,108	138,896	171,431	173,009	163,312	150,152	161,307	
Gross reestimated liability — latest	173,661	190,465	206,314	208,071	238,864	240,491	240,244	229,755		
Reestimated recoverable — latest	66,826	77,544	87,709	88,103	91,584	88,699	89,310	76,919		
Net reestimated liability — latest	106,835	112,921	118,605	119,968	147,280	151,792	150,934	152,836		
Gross cumulative deficiency (excess)	17,185	10,625	(4,378)	(9,843)	(28,326)	(25,239)	(18,778)	3,323		

Technology

Donegal Mutual owns the majority of the technology systems our insurance subsidiaries use. The technology systems consist primarily of an integrated central processing computer, a series of server-based computer networks and various communications systems that allow the home office of our insurance subsidiaries and their branch offices to utilize the same systems for the processing of business. Donegal Mutual maintains backup facilities and systems through a contract with a leading provider of computer disaster recovery sites and tests these backup facilities and systems on a regular basis. Atlantic States, Southern, the Peninsula Companies and Sheboygan bear their proportionate share of information services expenses based on their proportionate percentages of the total net written premiums of the Donegal Insurance Group.

The business strategy of our insurance subsidiaries depends on the use, development and implementation of integrated technology systems. These systems enable our insurance subsidiaries to provide a high level of service to agents and policyholders by processing business in a timely and efficient manner, communicating and sharing data with agents, providing a variety of methods for the payment of premiums and allowing for the accumulation and analysis of information for the management of our insurance subsidiaries.

We believe the availability and use of these technology systems has resulted in improved service to agents and policyholders, increased efficiencies in processing the business of our insurance subsidiaries and lower operating costs. Three key components of these integrated technology systems are the agency interface system, the WritePro® and WriteBiz® systems and an imaging system. The agency interface system provides our insurance subsidiaries with a high level of data sharing both to and from agents' systems and also provides agents with an integrated means of processing new business. The WritePro® and WriteBiz® systems are fully automated underwriting and policy issuance systems that provide agents with the ability to generate underwritten quotes and automatically issue policies that meet the underwriting guidelines of our insurance subsidiaries with limited or no intervention by their personnel. The imaging system eliminates the need to handle paper files, while providing greater access to the same information by a variety of personnel.

Third-Party Reinsurance

Atlantic States, Southern and Donegal Mutual purchase reinsurance on a combined basis. Le Mars, the Peninsula Companies and Sheboygan have separate reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries use a number of different reinsurers, all of which reinsurers, consistent with the requirements of our insurance subsidiaries, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a

financial condition that, in the opinion of our management, is equivalent to a company with at least an A.M. Best A- rating.

The external reinsurance Atlantic States, Southern and Donegal Mutual purchase includes:

- “excess of loss reinsurance,” under which losses are automatically reinsured, through a series of contracts, over a set retention (\$600,000 for 2008); and
- “catastrophic reinsurance,” under which our insurance subsidiaries recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million for 2008).

The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risk being reinsured.

The principal third-party reinsurance agreement of our insurance subsidiaries in 2008 was a multi-line per risk excess of loss treaty that provides 100% coverage up to \$1.0 million for both property and liability losses.

For property insurance, in 2008 our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$2.5 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$40.0 million per occurrence. For workers’ compensation insurance in 2008, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$10.0 million on any one life.

Our insurance subsidiaries have property catastrophe coverage through a series of layered treaties up to aggregate losses of \$100.0 million for Atlantic States, Southern and Donegal Mutual for any single event.

Our insurance subsidiaries purchase facultative reinsurance to cover exposures from property and casualty losses that exceed the limits provided by their respective treaty reinsurance.

Competition

The property and casualty insurance industry is highly competitive on the basis of both price and service. Numerous companies compete for business in the geographic areas where our insurance subsidiaries operate, many of which are substantially larger and have greater financial resources than those of our insurance subsidiaries. In addition, because the insurance products of our insurance subsidiaries and those of Donegal Mutual are marketed

exclusively through independent insurance agencies, most of which represent more than one insurance company, our insurance subsidiaries face competition within agencies as well as competition to retain qualified independent agents.

Investments

Return on invested assets is an important element of the financial results of our insurance subsidiaries, and the investment strategy of our insurance subsidiaries is to generate an appropriate amount of after-tax income on invested assets while minimizing credit risk through investments in high-quality securities. As a result, our insurance subsidiaries seek to invest a high percentage of their assets in diversified, highly rated and marketable fixed-maturity instruments. The fixed-maturity portfolios of our insurance subsidiaries consist of both taxable and tax-exempt securities. Our insurance subsidiaries maintain a portion of their portfolios in short-term securities, such as investments in commercial paper, to provide liquidity for the payment of claims and operation of their businesses. Our insurance subsidiaries maintain a negligible percentage (less than 1% at December 31, 2008) of their portfolios in equity securities.

At December 31, 2008, 99.5% of all debt securities held by our insurance subsidiaries had an investment-grade rating. The investment portfolios of our insurance subsidiaries did not contain any mortgage loans or any non-performing assets at December 31, 2008.

The following table shows the composition of the debt securities (at carrying value) in the investment portfolios of our insurance subsidiaries, excluding short-term investments, by rating as of December 31, 2008:

(dollars in thousands) Rating(1)	December 31, 2008	
	Amount	Percent
U.S. Treasury and U.S. agency securities(2)	\$ 99,963	18.3%
Aaa or AAA	193,127	35.4
Aa or AA	198,675	36.4
A	48,732	8.9
BBB	2,350	0.5
CCC	1,641	0.3
D	1,206	0.2
Total	<u>\$ 545,694</u>	<u>100.0%</u>

(1) Ratings assigned by Moody's Investors Services, Inc. or Standard & Poor's Corporation.

(2) Includes mortgage-backed securities of \$84.8 million.

Our insurance subsidiaries invest in both taxable and tax-exempt securities as part of their strategy to maximize after-tax income and are currently increasing their investments in

tax-exempt securities. This strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 59.7%, 67.9% and 75.8% of the debt securities in the investment portfolios of our insurance subsidiaries at December 31, 2006, 2007 and 2008, respectively.

The following table shows the classification of the investments of our insurance subsidiaries (at carrying value) at December 31, 2006, 2007 and 2008:

(dollars in thousands)	2006		December 31, 2007		2008	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 58,094	9.8%	\$ 51,611	8.5%	\$ 8,517	1.4%
Obligations of states and political subdivisions	83,283	14.1	81,457	13.5	76,451	12.1
Corporate securities	14,638	2.5	9,838	1.6	8,341	1.3
Mortgage-backed securities	13,163	2.2	11,384	1.9	6,569	1.0
Total held to maturity	<u>169,178</u>	<u>28.6</u>	<u>154,290</u>	<u>25.5</u>	<u>99,878</u>	<u>15.8</u>
Available for sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	44,836	7.6	25,374	4.2	6,630	1.0
Obligations of states and political subdivisions	215,518	36.5	251,866	41.6	337,003	53.3
Corporate securities	18,476	3.1	15,228	2.5	23,936	3.8
Mortgage-backed securities	52,840	8.9	43,850	7.2	78,247	12.4
Total available for sale	<u>331,670</u>	<u>56.1</u>	<u>336,318</u>	<u>55.5</u>	<u>445,816</u>	<u>70.5</u>
Total fixed maturities	500,848	84.7	490,608	81.0	545,694	86.3
Equity securities(2)	36,813	6.2	36,361	6.0	5,895	0.9
Investments in affiliates(3)	8,463	1.4	8,649	1.4	8,594	1.4
Short-term investments(4)	45,214	7.7	70,252	11.6	71,953	11.4
Total investments	<u>\$ 591,338</u>	<u>100.0%</u>	<u>\$ 605,870</u>	<u>100.0%</u>	<u>\$ 632,136</u>	<u>100.0%</u>

(1) Our insurance subsidiaries account for their investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting For Certain Investments in Debt and Equity Securities." See Notes 1 and 5 to our consolidated financial statements incorporated by reference herein. We value fixed maturities classified as held to maturity at amortized cost; we value those fixed maturities classified as available for sale at fair value. Total fair value of fixed maturities classified as held to maturity was \$168.4 million at December 31, 2006, \$155.4 million at December 31, 2007 and \$101.5 million at December 31, 2008. The amortized cost of fixed maturities classified as available for sale was \$330.4 million at December 31, 2006, \$331.8 million at December 31, 2007 and \$449.0 million at December 31, 2008.

(2) We value equity securities at fair value. Total cost of equity securities was \$29.8 million at December 31, 2006, \$30.0 million at December 31, 2007 and \$2.9 million at December 31, 2008.

(3) We value investments in affiliates at cost, adjusted for our share of earnings and losses of our affiliates as well as changes in equity of our affiliates due to unrealized gains and losses.

(4) We value short-term investments at cost, which approximates market.

The following table sets forth the maturities (at carrying value) in fixed maturity and short-term investment portfolios of our insurance subsidiaries at December 31, 2006, December 31, 2007 and December 31, 2008:

(dollars in thousands)	December 31,					
	2006		2007		2008	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Due in(1):						
One year or less	\$ 72,966	13.5%	\$ 29,299	6.0%	\$ 14,008	2.6%
Over one year through three years	68,468	12.6	61,523	12.5	33,772	6.2
Over three years through five years	43,453	8.0	36,360	7.4	44,579	8.2
Over five years through ten years	171,579	31.6	186,441	38.0	174,130	31.9
Over ten years through fifteen years	113,714	20.9	86,089	17.5	89,889	16.5
Over fifteen years	6,150	1.2	35,662	7.3	104,500	19.1
Mortgage-backed securities	66,003	12.2	55,234	11.3	84,816	15.5
	<u>\$ 542,333</u>	<u>100.0%</u>	<u>\$ 490,608</u>	<u>100.0%</u>	<u>\$ 545,694</u>	<u>100.0%</u>

(1) Based on stated maturity dates with no prepayment assumptions. Actual maturities will differ because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

As shown above, our insurance subsidiaries held investments in mortgage-backed securities having a carrying value of \$84.8 million at December 31, 2008. The mortgage-backed securities consist primarily of investments in governmental agency balloon pools with stated maturities between one and 24 years. The stated maturities of these investments limit the exposure of our insurance subsidiaries to extension risk should interest rates rise and prepayments decline. Our insurance subsidiaries perform an analysis of the underlying loans when evaluating a mortgage-backed security for purchase, and they select those securities that they believe will provide a return that properly reflects the prepayment risk associated with the underlying loans.

The following table sets forth the investment results of our insurance subsidiaries for the years ended December 31, 2006, 2007 and 2008:

(dollars in thousands)	Year Ended December 31,		
	2006	2007	2008
Invested assets(1)	\$569,542	\$598,604	\$619,003
Investment income(2)	21,320	22,785	22,756
Average yield	3.7%	3.8%	3.7%
Average tax-equivalent yield	4.7	4.8	4.9

-
- (1) Average of the aggregate invested amounts at the beginning and end of the period.
 - (2) Investment income is net of investment expenses and does not include realized investment gains or losses or provision for income taxes.

A.M. Best Rating

Donegal Mutual and our insurance subsidiaries have an A.M. Best rating of A (Excellent), based upon their respective current financial condition and historical statutory results of operations and retrocessional agreements. We believe that the A.M. Best rating of Donegal Mutual and our insurance subsidiaries is an important factor in their marketing of their products to their agents and customers. A.M. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies. A.M. Best's classifications are A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Very Good), B and B- (Good), C++ and C+ (Fair), C and C- (Marginal), D (Below Minimum Standards) and E and F (Liquidation). A.M. Best's ratings are based upon factors relevant to the payment of claims of policyholders and are not directed toward the protection of investors in insurance companies. According to A.M. Best, the "Excellent" rating that the Donegal Insurance Group maintains is assigned to those companies that, in A.M. Best's opinion, have an excellent ability to meet their ongoing obligations to policyholders.

Regulation

Insurance companies are subject to supervision and regulation in the states in which they transact business. Such supervision and regulation relate to numerous aspects of an insurance company's business and financial condition. The primary purpose of such supervision and regulation is the protection of policyholders. The extent of such regulation varies, but generally derives from state statutes that delegate regulatory, supervisory and administrative authority to state insurance departments. Accordingly, the authority of the state insurance departments includes the establishment of standards of solvency that must be met and maintained by insurers, the licensing of insurers and agents to do business, the nature of and limitations on investments, premium rates for property and casualty insurance, the provisions that insurers must make for current losses and future liabilities, the deposit of securities for the benefit of policyholders, the approval of policy forms, notice requirements for the cancellation of policies and the approval of certain changes in control. State insurance departments also conduct periodic examinations of the affairs of insurance companies and require the filing of annual and other reports relating to the financial condition of insurance companies.

In addition to state-imposed insurance laws and regulations, the National Association of Insurance Commissioners (the "NAIC") has established a risk-based capital system for assessing the adequacy of statutory capital and surplus that augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 2008,

our insurance subsidiaries and Donegal Mutual each exceeded the minimum levels of statutory capital the risk-based capital rules require by a substantial margin.

Generally, every state has guaranty fund laws under which insurers licensed to do business in that state can be assessed on the basis of premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder claims against insolvent insurers. Our insurance subsidiaries and Donegal Mutual have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations.

Most states have legislation that regulates insurance holding company systems. Each insurance company in the insurance holding company system is required to register with the insurance supervisory agency of its state of domicile and furnish information concerning the operations of companies within the insurance holding company system that may materially affect the operations, management or financial condition of the insurers within the system. Pursuant to these laws, the respective insurance departments may examine our insurance subsidiaries or Donegal Mutual at any time, require disclosure of material transactions by the holding company with another member of the insurance holding company system and require prior notice or prior approval of certain transactions, such as "extraordinary dividends" from the insurance subsidiaries to the holding company.

The Pennsylvania Insurance Holding Companies Act, which generally applies to Donegal Mutual, us and our insurance subsidiaries, requires that all transactions within an insurance holding company system to which an insurer is a party must be fair and reasonable and that any charges or fees for services performed must be reasonable. Any management agreement, service agreement, cost sharing arrangement and reinsurance agreement must be filed with the Pennsylvania Insurance Department (the "Department") and is subject to Department review. We have filed the pooling agreement between Donegal Mutual and Atlantic States that established the underwriting pool and the reinsurance agreements between Donegal Mutual and our insurance subsidiaries with the Department.

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In virtually all states, including Pennsylvania, Iowa, Maryland, Virginia and Wisconsin where our insurance subsidiaries are domiciled, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company or the intent to acquire such an interest creates a rebuttable presumption of a change in control. Pursuant to an order issued in April 2003, the Department approved Donegal Mutual's ownership of up to 70% of our outstanding Class A common stock and up to 100% of our outstanding Class B common stock.

Our insurance subsidiaries participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in the states in which they operate. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements (FAIR) plans, reinsurance facilities, windstorm plans and tornado plans. Legislation establishing these programs requires all companies that write lines covered by these programs to provide coverage, either directly or through reinsurance, for insureds who cannot obtain insurance in the voluntary market. The legislation creating these programs usually allocates a pro rata portion of risks attributable to such insureds to each company on the basis of direct premiums written or the number of automobiles insured in the particular state. Generally, state law requires participation in such programs as a condition to doing business. The loss ratio on insurance written under involuntary programs has traditionally been greater than the loss ratio on insurance written in the voluntary market.

The insurance laws of the respective states of domicile of our insurance subsidiaries restrict the amount of dividends or other distributions our insurance subsidiaries may pay to us without the prior approval of the insurance regulatory authorities of that state. Generally, the maximum amount that an insurance subsidiary may pay during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary's statutory capital and surplus as of the end of the preceding year or the net income of the subsidiary for the preceding year. As of December 31, 2008, the amount of dividends our insurance subsidiaries could pay us during 2009, without the prior approval of the various insurance commissioners, was:

Name of Insurance Subsidiary	Ordinary Dividend Amount
Atlantic States	\$18.4 million
Southern	1.6 million
Le Mars	2.8 million
Peninsula Companies	3.9 million
Sheboygan	None
Total	<u>\$26.7 million</u>

Donegal Mutual

Donegal Mutual organized as a mutual fire insurance company in Pennsylvania in 1889. At December 31, 2008, Donegal Mutual had admitted assets of \$304.5 million and policyholders' surplus of \$158.0 million. At December 31, 2008, Donegal Mutual had total liabilities of \$146.5 million, including debt of \$6.6 million, reserves for net losses and loss expenses of \$48.4 million and unearned premiums of \$27.5 million. Of Donegal Mutual's investment portfolio of \$244.3 million at December 31, 2008, investment-grade bonds accounted for \$14.2 million and mortgages accounted for \$3.2 million. At December 31, 2008, Donegal Mutual owned 8,355,184 shares, or approximately 42%, of our Class A common

stock, Donegal Mutual carried on its books at \$108.1 million, and 4,153,666 shares, or approximately 75%, of our Class B common stock, Donegal Mutual carried on its books at \$53.7 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. Donegal Mutual does not, nor is it required to, prepare financial statements in accordance with generally accepted accounting principles.

Donegal Financial Services Corporation

Because of Donegal Mutual's and our ownership of DFSC, both Donegal Mutual and we are regulated as unitary savings and loan holding companies. As such, Donegal Mutual and we are subject to regulation by the Office of Thrift Supervision, or the OTS, under the holding company provisions of the federal Home Owners' Loan Act. As a federally chartered and insured stock savings association, Province Bank is subject to regulation and supervision by the OTS, which is the primary regulator of federal savings banks, and by the Federal Deposit Insurance Corporation. The primary purpose of the statutory and regulatory scheme is to protect depositors, the financial institutions and the financial system as a whole rather than the shareholders of financial institutions or their holding companies.

Transactions between a savings association and its "affiliates" are subject to quantitative and qualitative restrictions under Sections 23A and 23B of the Federal Reserve Act. Affiliates of a savings association include, among other entities, the savings association's holding company and non-banking companies that are under common control with the savings association. These restrictions on transactions with affiliates apply to transactions between DFSC and Province Bank, on the one hand, and us and our insurance subsidiaries, on the other hand. These restrictions also apply to transactions among DFSC, Province Bank and Donegal Mutual.

Cautionary Statement Regarding Forward-Looking Statements

This annual report and the documents incorporated by reference into this annual report contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies, reserves, profitability and business relationships and our other business activities during 2008 and beyond. In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "could," "would," "expect," "plan," "intend," "anticipate," "believe," "estimate," "objective," "project," "predict," "potential," "goal" and similar expressions. These forward-looking statements reflect our current views about future events, are based on our current assumptions and are subject to known and unknown risks and uncertainties that may cause our results, performance or achievements to differ materially from those anticipated in or implied by those statements. Many of the factors that will determine future events or

achievements are beyond our ability to control or predict. Such factors may include those described under “Risk Factors.” The forward-looking statements contained in this annual report reflect our views and assumptions only as of the date of this Form 10-K Report. Except as required by law, we do not intend to, and assume no responsibility for, updating any forward-looking statements. We qualify all of our forward-looking statements by these cautionary statements.

Available Information

Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and our other filings pursuant to the Securities Exchange Act of 1934, or the Exchange Act, are available without charge on our website, www.donegalgroup.com, as soon as reasonably practicable after we file them electronically with the Securities and Exchange Commission, or SEC. Our Code of Business Conduct and Ethics and the charters of our audit committee and our nominating committee are available on our website. Upon request to our corporate secretary, printed copies are also available. We are providing the address to our website solely for the information of investors. We do not intend the reference to our website address to be an active link or to otherwise incorporate the contents of the website into this Form 10-K report.

Item 1A. Risk Factors.

Risk Factors

Risks Relating to Us and Our Business

Donegal Mutual is our controlling stockholder, and it and its directors and executive officers have potential conflicts of interest between the best interests of our stockholders and the best interests of the policyholders of Donegal Mutual.

Donegal Mutual controls the election of all of the members of our board of directors. Four of the nine members of our board of directors are also directors of Donegal Mutual. Donegal Mutual and we have the same executive officers. These common directors and executive officers have a fiduciary duty to our stockholders and also have a fiduciary duty to the policyholders of Donegal Mutual. Among the potential conflicts of interest that could arise from these separate fiduciary duties are:

- We and Donegal Mutual periodically review the percentage participation of Atlantic States and Donegal Mutual in the underwriting pool that the two companies have maintained since 1986;
- Our insurance subsidiaries and Donegal Mutual annually review and then establish the terms of certain reinsurance agreements between them with the

objective over the long-term of having an approximately equal balance between payments and recoveries;

- We and Donegal Mutual periodically allocate certain shared expenses among Donegal Mutual, us and our insurance subsidiaries in accordance with various inter-company expense-sharing agreements; and
- Our insurance subsidiaries may enter into other transactions or contractual relationships with Donegal Mutual, including, for example, our purchases from time to time from Donegal Mutual of the surplus note of a mutual insurance company that will convert into a stock insurance company.

Donegal Mutual has the power to determine the outcome of all matters submitted to our stockholders for approval.

Each share of our Class A common stock has one-tenth of a vote per share and votes as a single class with our Class B common stock which has one vote per share except for matters that would uniquely affect the rights of holders of our Class A common stock. Donegal Mutual has the right to vote approximately 66% of the aggregate voting power of our Class A common stock and our Class B common stock and has sufficient voting control to:

- elect all of the members of our board of directors, who determine our management and policies; and
- control the outcome of any corporate transaction or other matter submitted to our stockholders for approval, including mergers or other acquisition proposals and the sale of all or substantially all of our assets, in each case regardless of how our other stockholders vote their shares.

The interests of Donegal Mutual in maintaining its majority control of us may have an adverse effect on the price of our Class A common stock and our Class B common stock because of the absence of any potential “takeover” premium and may be inconsistent with the interests of our stockholders other than Donegal Mutual.

Donegal Mutual’s voting control of us, certain provisions of our certificate of incorporation and by-laws and certain provisions of Delaware law make it unlikely that anyone could acquire control of us unless Donegal Mutual were in favor of the acquisition of control.

Donegal Mutual’s voting control of us, certain anti-takeover provisions in our certificate of incorporation and by-laws and certain provisions of the Delaware General Corporation Law (the “DGCL”), could delay or prevent the removal of members of our board of directors and could make more difficult or more expensive a merger, tender offer or proxy contest involving us to succeed, even if such events were in the best interests of our stockholders other than Donegal Mutual. These factors could also discourage a third party

from attempting to acquire control of us. In particular, our certificate of incorporation and by-laws include the following anti-takeover provisions:

- our board of directors is classified into three classes, so that stockholders elect only one-third of the members of our board of directors each year;
- stockholders may remove our directors only for cause;
- stockholders may not take stockholder action except at an annual or special meeting of stockholders;
- the request of stockholders holding at least 20% of the voting power of our Class A common stock and our Class B common stock is required to call a special meeting of stockholders;
- stockholders are required to provide advance notice to us to nominate candidates for election to our board of directors or to make a stockholder proposal at a stockholders' meeting;
- cumulative voting rights are not available in the election of directors;
- pre-emptive rights are not available in connection with the issuance of securities by us; and
- our board of directors is permitted to issue, without stockholder approval unless otherwise required by law, preferred stock with such terms as our board of directors may determine.

Moreover, the DGCL contains certain provisions that prohibit certain business combination transactions with an interested stockholder under certain circumstances.

We have authorized preferred stock that we could issue to make it more difficult for a third party to acquire us.

We have 2,000,000 authorized shares of series preferred stock that we could issue without further stockholder approval, unless otherwise required by law, and upon such terms and conditions, and having such rights, privileges and preferences, as our board of directors may determine and that may make it difficult for a third party to acquire control of us.

Because we are an insurance holding company, no person can acquire or seek to acquire a 10% or greater interest in us without first obtaining approval of the insurance commissioners of the states of domicile of our insurance subsidiaries.

We own insurance subsidiaries domiciled in the states of Pennsylvania, Maryland, Virginia, Iowa and Wisconsin. The insurance laws of each of these states provide that no person can acquire or seek to acquire a 10% or greater interest in us without first filing specified information with the insurance commissioner of that state and obtaining the prior approval of the proposed acquisition of a 10% or greater interest in us by the state insurance commissioner based on statutory standards designed to protect the safety and soundness of the insurance holding company and its subsidiary.

Our insurance subsidiaries currently conduct business in a limited number of states, with a concentration of business in Pennsylvania, Maryland and Virginia. Any single catastrophe occurrence or other condition affecting losses in these states could adversely affect their results of operations.

Our insurance subsidiaries conduct business in states located primarily in the Mid-Atlantic, Midwestern and Southeastern portions of the United States. A substantial portion of their business consists of private passenger and commercial automobile, homeowners and workers' compensation insurance in Pennsylvania, Maryland and Virginia. While our insurance subsidiaries actively manage their exposure to catastrophes through their underwriting process and the purchase of reinsurance, a single catastrophe occurrence, destructive weather pattern, general economic trend, terrorist attack, regulatory development or other condition affecting one or more of the states in which our insurance subsidiaries conduct substantial business could materially adversely affect their business, financial condition and results of operations. Common catastrophic events include hurricanes, earthquakes, tornadoes, wind and hail storms, fires, explosions and severe winter storms.

The business, financial condition and results of operations of our insurance subsidiaries may be adversely affected if the independent agents who market the products of our insurance subsidiaries do not maintain their current levels of premium writing with us, fail to comply with established underwriting guidelines of our insurance subsidiaries or otherwise inappropriately market the products of our insurance subsidiaries.

Our insurance subsidiaries market their insurance products solely through a network of approximately 2,000 independent insurance agencies. This agency force is one of the most important components of the competitive profile of our insurance subsidiaries. As a result, our insurance subsidiaries are materially dependent upon the independent agents they use, each of whom has the authority to bind our insurance subsidiaries to insurance policies. To the extent that our independent agents' marketing efforts cannot maintain their current levels of volume and quality or they bind our insurance subsidiaries to unacceptable insurance risks, fail to comply with the established underwriting guidelines of our insurance subsidiaries or otherwise inappropriately market the products of our insurance subsidiaries, the business, financial condition and results of operations of our insurance subsidiaries could suffer.

The business of our insurance subsidiaries may not continue to grow and may be materially adversely affected if they cannot retain existing, and attract new, independent agents or if insurance consumers increase their use of other insurance marketing systems.

The continued growth of the business of our insurance subsidiaries will depend materially upon their ability to retain existing and to attract new independent agents. If independent agents find it easier to do business with the competitors of our insurance subsidiaries, our insurance subsidiaries could find it difficult to retain their existing business or to attract new business. While our insurance subsidiaries believe they maintain good relationships with the independent agents they appoint, our insurance subsidiaries cannot be certain that these independent agents will continue to sell the products of our insurance subsidiaries to the consumers these independent agents represent. Some of the factors that could adversely affect the ability of our insurance subsidiaries to retain existing and to attract new independent agents include:

- the significant competition to attract independent agents;
- the intense and time-consuming process of selecting new independent agents;
- the stringent criteria of our insurance subsidiaries which require that independent agents adhere to consistent underwriting standards; and
- the ability of our insurance subsidiaries to pay competitive and attractive commissions, bonuses and other incentives to independent agents.

While our insurance subsidiaries sell insurance solely through their network of independent agencies, many competitors of our insurance subsidiaries sell insurance through a variety of delivery methods, including independent agencies, captive agencies, the Internet and direct sales. To the extent that the policyholders that the independent agents of our insurance subsidiaries represent change their marketing system preference, the business, financial condition and results of operations of our insurance subsidiaries may be adversely affected.

We are dependent on dividends from our insurance subsidiaries for the payment of our operating expenses, our debt service and dividends to stockholders; however, there are limitations on the amount of dividends our insurance subsidiaries may pay to us.

As a holding company, we rely primarily on dividends from our insurance subsidiaries as a source of funds to meet our corporate obligations. The amount of dividends our insurance subsidiaries can pay to us is subject to regulatory restrictions and depends on the amount of surplus our subsidiaries maintain. From time to time, the NAIC and various state insurance regulators consider modifying the method of determining the amount of dividends that an insurance company may pay without prior regulatory approval. The maximum amount of ordinary dividends that our insurance subsidiaries can pay to us in

2009 without prior regulatory approval is approximately \$26.7 million. The ability of our insurance subsidiaries to pay dividends to us may be further constrained by business and regulatory considerations, such as the impact of dividends on surplus that could affect the ratings, competitive conditions, the investment results of our subsidiaries and the amount of premiums that our insurance subsidiaries can write as well as their ability to pay future dividends.

If A.M. Best downgrades the rating it has assigned to Donegal Mutual or our insurance subsidiaries, it would adversely affect their competitive position.

Industry ratings are a factor in establishing the competitive position of insurance companies. A.M. Best, an industry-accepted source of insurance company financial strength ratings, rates Donegal Mutual and our insurance subsidiaries. A.M. Best ratings provide an independent opinion of an insurance company's financial health and its ability to meet its obligations to its policyholders. We believe that the financial strength rating of A.M. Best is material to the operations of Donegal Mutual and our insurance subsidiaries. Currently, Donegal Mutual and our insurance subsidiaries each have an A (Excellent) rating from A.M. Best. If Donegal Mutual or any of our insurance subsidiaries were downgraded by A.M. Best, it would adversely affect the competitive position of Donegal Mutual and our insurance subsidiaries and make it more difficult for them to market their products and retain their existing policyholders.

Our strategy to grow in part through acquisitions of smaller insurance companies exposes us to risks that could adversely affect our results of operations and financial condition.

The acquisition of smaller and other undercapitalized insurance companies involves risks that could adversely affect our results of operations and financial condition. The risks associated with the acquisition of this type of company include:

- the potential inadequacy of its reserves for loss and loss expenses;
- the need to supplement management with additional experienced personnel;
- conditions imposed by regulatory agencies that make the realization of cost-savings through integration of operations more difficult;
- a need for additional capital that was not anticipated at the time of the acquisition; and
- the use of more of management time than originally anticipated.

If we cannot obtain sufficient capital to fund the organic growth of our insurance subsidiaries and to make acquisitions, we may not be able to expand our business.

Our strategy is to expand our business through the organic growth of our insurance subsidiaries and through our strategic acquisitions of regional insurance companies. Our insurance subsidiaries will require additional capital in the future to support this objective. If we cannot obtain sufficient capital on satisfactory terms and conditions, we may not be able to expand the business of our insurance subsidiaries or to make future acquisitions. Our ability to obtain additional financing will depend on a number of factors, many of which are beyond our control. For example, we may not be able to obtain additional financing because our insurance subsidiaries may already have substantial debt at the time, because we do not have sufficient cash flow to service or repay our existing or additional debt or because financial institutions are not making financing available. In addition, any equity capital we obtain in the future could be dilutive to our existing stockholders.

Many of the competitors of our insurance subsidiaries are financially stronger than our insurance subsidiaries are, and these competitors may be able to offer lower-priced products that our insurance subsidiaries may be unable to match.

The property and casualty insurance industry is intensely competitive. Competition is based on many factors, including the perceived financial strength of the insurer, premium rates, policy terms and conditions, policyholder service, reputation and experience. Our insurance subsidiaries compete with many regional and national property and casualty insurance companies, including direct sellers of insurance products, insurers having their own agency organizations and other insurers represented by independent agents. Many of these insurers are better capitalized than our insurance subsidiaries, have substantially greater financial, technical and operating resources than our insurance subsidiaries and have equal or higher ratings from A.M. Best. In addition, competition may become increasingly better capitalized in the future as the traditional barriers between insurance companies and other financial institutions erode and as the property and casualty insurance industry continues to consolidate.

The greater capitalization of many of the competitors of our insurance subsidiaries enables them to operate with lower profit margins and, therefore, allows them to market their products more aggressively, to take advantage more quickly of new marketing opportunities and to offer lower premium rates. Our insurance subsidiaries may not be able to maintain their current competitive position in the markets in which they operate if their competitors offer prices on products that are lower than the prices our insurance subsidiaries are prepared to offer. Moreover, if these competitors lower the price of their products and our insurance subsidiaries meet their pricing, the profit margins and revenues of our insurance subsidiaries may decrease and their ratios of claims and expenses to premiums may increase, which may materially adversely affect the financial condition and results of operations of our insurance subsidiaries.

Because the investment portfolios of our insurance subsidiaries consist primarily of fixed-income securities, their investment income and the fair value of their investment portfolios could decrease as a result of a number of factors.

Our insurance subsidiaries invest the premiums they receive from their policyholders and maintain investment portfolios that consist primarily of fixed-income securities. The management of these investment portfolios is an important component of their profitability because a significant portion of the operating income of our insurance subsidiaries is generated from the income they receive on their invested assets. The quality and/or yield of their portfolios may be affected by a number of factors, including the general economic and business environment, changes in the credit quality of the issuers of the fixed-income securities our insurance subsidiaries own, changes in market conditions and regulatory changes. The fixed-income securities our insurance subsidiaries own consist primarily of securities issued by domestic entities that are backed either by the credit or collateral of the underlying issuer. Factors such as an economic downturn, a regulatory change pertaining to a particular issuer's industry, a significant deterioration in the cash flows of the issuer or a change in the issuer's marketplace may adversely affect the ability of our insurance subsidiaries to collect principal and interest from the issuer.

The investments of our insurance subsidiaries are also subject to risk resulting from interest rate fluctuations. Increasing interest rates or a widening in the spread between interest rates available on U.S. Treasury securities and corporate debt or asset-backed securities, for example, will typically have an adverse impact on the market values of fixed-rate securities. If interest rates decline, our insurance subsidiaries would generally achieve a lower overall rate of return on investments of cash generated from their operations. In addition, in the event of the call or maturity of investments in a declining interest rate environment, our insurance subsidiaries may not be able to reinvest the proceeds in securities with comparable interest rates. Changes in interest rates may reduce both the profitability and the return on the invested capital of our insurance subsidiaries.

Our insurance subsidiaries depend on key personnel. The loss of any member of their senior management or our executive management could negatively affect the implementation of their business strategies and achievement of their growth objectives.

The loss of, or failure to attract, key personnel could significantly impede the financial plans, growth, marketing and other objectives of our insurance subsidiaries. Their success depends to a substantial extent on the ability and experience of their senior management. Our insurance subsidiaries believe that their future success is dependent on their ability to attract and retain additional skilled and qualified personnel and to expand, train and manage their employees. Our insurance subsidiaries may be unable to do so because the competition for experienced personnel in the insurance industry is intense. With limited exceptions, our insurance subsidiaries do not have employment agreements with their key personnel.

The reinsurance agreements on which our insurance subsidiaries rely do not relieve our insurance subsidiaries from their primary liability to their policyholders, and our insurance subsidiaries face a risk of non-payment from their reinsurers as well as the non-availability of reinsurance in the future.

Our insurance subsidiaries rely on reinsurance agreements to limit their maximum net loss from large single catastrophic risks or excess of loss risks in concentrated areas. Reinsurance also enables our insurance subsidiaries to increase their capacity to write insurance. Although the reinsurance our insurance subsidiaries maintain provides that the reinsurer is liable to them for any reinsured losses, the reinsurance does not relieve our insurance subsidiaries from their primary liability to their policyholders if the reinsurer fails to pay our insurance subsidiaries. To the extent that a reinsurer is unable to pay losses for which it is liable to our insurance subsidiaries, our insurance subsidiaries remain liable for such losses. As of December 31, 2008, our insurance subsidiaries had approximately \$27.7 million of reinsurance receivables from third-party reinsurers relating to paid and unpaid losses. The insolvency or inability of these reinsurers to make timely payments to our insurance subsidiaries under the terms of their reinsurance agreements would adversely affect the results of operations of our insurance subsidiaries.

In addition, our insurance subsidiaries face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect their ability to write business or their results of operations. Market conditions beyond the control of our insurance subsidiaries, such as the amount of surplus in the reinsurance market and the frequency and severity of natural and man-made catastrophes, affect both the availability and the cost of the reinsurance our insurance subsidiaries purchase. If our insurance subsidiaries could not maintain their current level of reinsurance or purchase new reinsurance protection in amounts that our insurance subsidiaries consider sufficient, our insurance subsidiaries would either have to be willing to accept an increase in their net risk retention or reduce their insurance writings which could adversely affect them.

Risks Relating to the Property and Casualty Insurance Industry

Industry trends, such as increased litigation against the insurance industry and individual insurers, the willingness of courts to expand covered causes of loss, rising jury awards, increasing medical costs and the escalation of loss severity may contribute to increased costs and to the deterioration of the reserves of our insurance subsidiaries.

Loss severity in the property and casualty insurance industry has increased in recent years, principally driven by larger court judgments and increasing medical costs. In addition, many classes of complainants have brought legal actions and proceedings which tends to increase the size of judgments. The propensity of policyholders and third-party claimants to litigate and the willingness of courts to expand causes of loss and the size of

awards may make the loss reserves of our insurance subsidiaries inadequate for current and future losses.

Loss or significant restriction of the use of credit scoring in the pricing and underwriting of the personal lines insurance products by our insurance subsidiaries could adversely affect their future profitability.

Our insurance subsidiaries use credit scoring as a factor in making risk selection and pricing decisions where allowed by state law for personal lines insurance products. Recently, some consumer groups and regulators have questioned whether the use of credit scoring unfairly discriminates against people with low incomes, minority groups and the elderly. These consumer groups and regulators often call for the prohibition or restriction on the use of credit scoring in underwriting and pricing. Laws or regulations enacted in a number of states that significantly curtail the use of credit scoring in the underwriting process could reduce the future profitability of our insurance subsidiaries.

Changes in applicable insurance laws or regulations or changes in the way regulators administer those laws or regulations could adversely affect the operating environment of our insurance subsidiaries and increase their exposure to loss or put them at a competitive disadvantage.

Property and casualty insurers are subject to extensive supervision in the states in which they do business. This regulatory oversight includes, by way of example, matters relating to licensing and examination, rate setting, market conduct, policy forms, limitations on the nature and amount of certain investments, claims practices, mandated participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, transactions between affiliates, the amount of dividends that insurers may pay and restrictions on underwriting standards. Such regulation and supervision are primarily for the benefit and protection of policyholders and not for the benefit of stockholders. For instance, our insurance subsidiaries are subject to involuntary participation in specified markets in various states in which they operate, and the premium rates our insurance subsidiaries may charge do not always correspond with the underlying costs of providing that coverage.

The NAIC and state insurance regulators are re-examining existing laws and regulations, specifically focusing on insurance company investments, issues relating to the solvency of insurance companies, risk-based capital guidelines, restrictions on the terms and conditions included in insurance policies, certain methods of accounting, reserves for unearned premiums, losses and other purposes, the values at which they may carry investment securities and the definition of other than temporarily impaired, interpretations of existing laws and the development of new laws. Changes in state laws and regulations, as well as changes in the way state regulators view related-party transactions in particular, could change the operating environment of our insurance subsidiaries and have an adverse effect on their business.

The state insurance regulatory framework has recently come under increased federal scrutiny. Congress is considering proposals that it should create an optional federal charter for insurers. Federal chartering has the potential to create an uneven playing field for insurers by subjecting federally-chartered and state-chartered insurers to different regulatory requirements. Federal chartering also raises the possibility of duplicative or conflicting federal and state requirements. In addition, if federal legislation repeals the partial exemption for the insurance industry from federal antitrust laws, our ability to collect and share loss cost data with the industry, could adversely affect the results of operations of our insurance subsidiaries.

Our insurance subsidiaries are subject to assessments, based on their market share in a given line of business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies. Such assessments could adversely affect the financial condition of our insurance subsidiaries.

Our insurance subsidiaries must pay assessments pursuant to the guaranty fund laws of the various states in which they conduct business. Generally, under these laws, our insurance subsidiaries can be assessed, depending upon their market share of a given line of insurance business, to assist in the payment of unpaid claims and related costs of insolvent insurance companies in those states. We cannot predict the number and magnitude of future insurance company failures in the states in which our insurance subsidiaries conduct business, but future assessments could adversely affect the business, financial condition and results of operations of our insurance subsidiaries.

Our insurance subsidiaries must establish premium rates and loss and loss expense reserves from forecasts of the ultimate costs expected to arise from risks underwritten during the policy period, and the profitability of our insurance subsidiaries could be adversely affected to the extent their premium rates or reserves are insufficient to satisfy their ultimate costs.

One of the distinguishing features of the property and casualty insurance industry is that it prices its products before its costs are known since premium rates are generally determined before the reporting of any losses. Accordingly, our insurance subsidiaries establish premium rates from forecasts of the ultimate costs they expect to arise from risks they have underwritten during the policy period, and their premium rates may not be sufficient to cover the ultimate losses incurred. Further, our insurance subsidiaries must establish reserves for losses and loss expenses based upon estimates involving actuarial and statistical projections at a given time of what our insurance subsidiaries expect their ultimate liability to be. It is possible that their ultimate liability could exceed these estimates because of the future development of known losses, the existence of losses that have occurred but are currently unreported and larger than historical settlements on pending and unreported claims. The process of estimating reserves is inherently judgmental and can be influenced by factors that are subject to variation. If the premium rates or reserves our insurance

subsidiaries establish are not sufficient, their business, financial condition and results of operations may be adversely impacted.

The cyclical nature of the property and casualty insurance industry may reduce the revenues and profit margins of our insurance subsidiaries.

The property and casualty insurance industry is highly cyclical. Individual lines of business experience their own cycles within the overall insurance industry cycle. Premium rate levels relate to the availability of insurance coverage, which varies according to the level of surplus in the insurance industry. The level of surplus in the industry varies with returns on invested capital and regulatory barriers to withdrawal of surplus. Increases in surplus are accompanied by increased price competition among property and casualty insurers. If our insurance subsidiaries find it necessary to reduce premiums or limit premium increases due to these competitive pressures on pricing, our insurance subsidiaries may experience a reduction in their profit margins and revenues, an increase in their ratios of losses and expenses to premiums and, therefore, lower profitability.

Risks Relating to Our Class A Common Stock

The price of our Class A common stock may be adversely affected by its low trading volume.

Our Class A common stock has limited liquidity. Reported average daily trading volume in our Class A common stock for the year ended December 31, 2008 was approximately 35,000 shares. This limited liquidity subjects our shares of Class A common stock to greater price volatility.

Donegal Mutual's ownership of our stock, anti-takeover provisions of our certificate of incorporation and by-laws and certain state laws make it unlikely anyone could acquire control of us unless Donegal Mutual were in favor of the acquisition of control.

Donegal Mutual's ownership of our Class A common stock and Class B common stock, certain anti-takeover provisions of our certificate of incorporation and by-laws, certain provisions of Delaware law and the insurance laws and regulations of Pennsylvania, Maryland, Iowa, Virginia and Wisconsin could delay or prevent the removal of members of our board of directors and could make it more difficult for a merger, tender offer or proxy contest involving us to succeed, even if our stockholders other than Donegal Mutual believed such events were beneficial to them. These factors could also discourage a third party from attempting to acquire control of us. The classification of our board of directors could also have the effect of delaying or preventing a change in control of us.

In addition, we have 2,000,000 authorized shares of series preferred stock that we could issue without stockholder approval, to the extent permitted by applicable law, and upon such terms and conditions, and having such rights, privileges and preferences, as our

board of directors may determine. Our ability to issue preferred stock could make it difficult for a third party to acquire us. We have no current plans to issue any preferred stock.

Moreover, the DGCL contains certain provisions that prohibit certain business combination transactions under certain circumstances. In addition, state insurance laws and regulations generally prohibit any person from acquiring, or seeking to acquire, a 10% or greater interest in an insurance company without the prior approval of the state insurance commissioner of the state where the insurer is domiciled.

Item 1B. Unresolved Staff Comments.

We have no unresolved written comments from the SEC staff regarding our filings under the Exchange Act.

Item 2. Properties.

We and our insurance subsidiaries share headquarters with Donegal Mutual in a building in Marietta, Pennsylvania owned by Donegal Mutual. Donegal Mutual charges us and our insurance subsidiaries for an appropriate portion of the building expenses under an inter-company allocation agreement. The Marietta headquarters has approximately 206,600 square feet of office space. Southern owns a facility of approximately 10,000 square feet in Glen Allen, Virginia. Le Mars owns a facility of approximately 25,500 square feet in Le Mars, Iowa, the Peninsula Companies own a facility of approximately 14,600 square feet in Salisbury, Maryland and Sheboygan owns a facility of approximately 8,800 square feet in Sheboygan Falls, Wisconsin.

Item 3. Legal Proceedings.

Our insurance subsidiaries are a party to numerous lawsuits arising in the ordinary course of their insurance business. We believe that the resolution of these lawsuits will not have a material adverse effect on the financial condition or results of operations of our insurance subsidiaries.

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

We did not submit any matter to a vote of the holders of our Class A common stock or Class B common stock during the fourth quarter of 2008.

Executive Officers of the Company.

The following table sets forth information regarding the executive officers of Donegal Mutual and us, each of whom has served with us for more than 10 years:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Donald H. Nikolaus	66	President and Chief Executive Officer of Donegal Mutual since 1981; President and Chief Executive Officer of us since 1986.
Robert G. Shenk	55	Senior Vice President, Claims, of Donegal Mutual and us since 1997; other positions from 1986 to 1997.
Cyril J. Greenya	64	Senior Vice President and Chief Underwriting Officer, of Donegal Mutual and us since 2005, Senior Vice President, Underwriting of Donegal Mutual from 1997 to 2005; other positions from 1986 to 2005.
Daniel J. Wagner	48	Senior Vice President and Treasurer of Donegal Mutual and us since 2005; Vice President and Treasurer of Donegal Mutual and us from 2000 to 2005; other positions from 1993 to 2005.
Jeffrey D. Miller	44	Senior Vice President and Chief Financial Officer of Donegal Mutual and us since 2005; Vice President and Controller of Donegal Mutual and us from 2000 to 2005; other positions from 1995 to 2005.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

We incorporate the response to this Item in part by reference to page 42 of our Annual Report to Stockholders for the year ended December 31, 2008, which we include as Exhibit (13) to this Form 10-K Report. As of February 27, 2009, we had approximately 1,154 holders of record of our Class A common stock and approximately 422 holders of record of our Class B common stock. We declared dividends of \$0.36 per share on our Class A common stock and \$0.31 per share on our Class B common stock in 2007 and \$0.42 per share on our Class A common stock and \$0.37 per share on our Class B common stock in 2008.

Between October 1, 2008 and December 31, 2008, we and Donegal Mutual purchased shares of our Class A common stock and Class B common stock as set forth in the following table.

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1 October 1-31, 2008	Class A – — Class B – —	Class A – \$— Class B – \$—	Class A – — Class B – —	
Month #2 November 1-30, 2008	Class A – 35,000 Class B – 20,337	Class A – \$14.47 Class B – \$18.75	Class A – 35,000 Class B – 20,337	(2) (1)
Month #3 December 1-31, 2008	Class A – 35,100	Class A – \$15.81	Class A – 35,100	(2)
Total	Class A – 70,100 Class B – 20,337	Class A – \$15.14 Class B – \$18.75	Class A – 70,100 Class B – 20,337	

- (1) Donegal Mutual purchased these shares pursuant to its announcement on August 17, 2004 that it will, at its discretion, purchase shares of Class A common stock and Class B common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. Such announcement did not stipulate a maximum number of shares that Donegal Mutual may purchase.

(2) We announced on March 7, 2008 that we will purchase up to 500,000 shares of Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We have 19,231 additional shares of Class A common stock available for purchase under this program.

Our performance graph is included on page 41 of our Annual Report to Stockholders for the year ended December 31, 2008, which we include as Exhibit (13) to this Form 10-K Report. Our performance graph is not deemed filed with the SEC and is not deemed incorporated by reference into any filing we make under the Securities Act of 1933 or the Exchange Act, except to the extent that we specifically incorporate it by reference.

Item 6. Selected Financial Data.

We incorporate the response to this Item by reference to page 8 of our Annual Report to Stockholders for the year ended December 31, 2008, which we include as Exhibit (13) to this Form 10-K Report.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

We incorporate the response to this Item by reference to pages 10 through 18 of our Annual Report to Stockholders for the year ended December 31, 2008, which we include as Exhibit (13) to this Form 10-K Report.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Our insurance subsidiaries are exposed to the impact of changes in interest rates, market values of investments and credit risk.

In the normal course of business, our insurance subsidiaries employ established policies and procedures to manage their exposure to changes in interest rates, fluctuations in the fair market value of our debt and equity securities and credit risk. Our insurance subsidiaries seek to mitigate these risks by various actions described below.

Interest Rate Risk

The exposure of our insurance subsidiaries to market risk for a change in interest rates is concentrated in their investment portfolios. Our insurance subsidiaries monitor this exposure through periodic reviews of asset and liability positions. Our insurance subsidiaries regularly monitor their estimates of cash flows and the impact of interest rate fluctuations relating to their investment portfolio. Generally, our insurance subsidiaries do not hedge their exposure to interest rate risk because they have the capacity to, and do, hold fixed-maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates held by our insurance subsidiaries are as follows:

(amounts in thousands)	As of December 31, 2008	
	Principal cash flows	Weighted-average interest rate
<i>Fixed maturities and short-term investments:</i>		
2009	\$ 86,238	1.3%
2010	22,397	5.4
2011	17,513	5.1
2012	23,615	4.8
2013	18,542	5.1
Thereafter	456,137	4.5
Total	<u>\$ 624,442</u>	
Market value	<u>\$ 624,961</u>	
<i>Debt:</i>		
2033	\$ 15,465	6.9%
Total	<u>\$ 15,465</u>	
Fair Value	<u>\$ 15,465</u>	

Actual cash flows from investments may differ from those stated as a result of calls and prepayments.

Equity Price Risk

The marketable equity securities portfolios of our insurance subsidiaries, which they carry on their consolidated balance sheets at estimated fair value, have exposure to equity price risk, which is the risk of potential loss in estimated fair value resulting from an adverse change in prices. The objective of our insurance subsidiaries is to earn competitive relative returns by investing in diverse portfolios of high-quality, liquid securities.

Credit Risk

The fixed-maturity securities portfolios of our insurance subsidiaries and, to a lesser extent, the short-term investments of our insurance subsidiaries are subject to credit risk. This risk is the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. Our insurance subsidiaries manage this risk by performing pre-investment underwriting analysis and through regular reviews by their investment staff. We limit the amount of fixed-maturity investments of our insurance subsidiaries to a minimum and maximum percentage of their total unvested assets.

Our insurance subsidiaries provide property and casualty insurance coverages through a network of independent insurance agencies located throughout the operating areas of our insurance subsidiaries. Our insurance subsidiaries bill the majority of this business

directly to the policyholder, although our insurance subsidiaries bill a portion of their commercial business through the agents of our insurance subsidiaries, who extend credit to agents in the normal course of their business.

Our insurance subsidiaries place reinsurance with Donegal Mutual and with major unaffiliated authorized reinsurers. To the extent that a reinsurer is unable to pay losses for which it is liable to our insurance subsidiaries under the terms of its reinsurance agreement with our insurance subsidiaries, our insurance subsidiaries remain liable for such losses.

Item 8. Financial Statements and Supplementary Data.

We incorporate the response to this Item by reference to pages 19 through 37 of our Annual Report to Stockholders for the year ended December 31, 2008, which we include as Exhibit (13) to this Form 10-K Report.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief 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 Exchange Act) as of the end of the period covered by this Form 10-K Report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information we are required to disclose in the reports that we file or submit under the Exchange Act and our disclosure controls and procedures are also effective to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we include a report of management's assessment of the design and effectiveness of our internal controls as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Report. KPMG LLP, an independent registered public accounting firm, audited the effectiveness of

our internal control over financial reporting as of December 31, 2008 based on criteria established by Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. We include the report of KPMG LLP dated March 11, 2009 as part of our Annual Report to Stockholders incorporated by reference in this Form 10-K Report.

Changes in Internal Control over Financial Reporting

We have not changed our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance of the Registrant.

We incorporate the response to this Item with respect to our directors by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 16, 2009. We incorporate the response to this Item with respect to our executive officers by reference to Part I of this Form 10-K Report.

We incorporate the full text of our Code of Business Conduct and Ethics by reference to Exhibit 14 to this Form 10-K Report.

Item 11. Executive Compensation.

We incorporate the response to this Item by reference to our proxy statement filed with the SEC relating to our annual meeting of stockholders to be held April 16, 2009. Neither the Report of our Compensation Committee nor the Report of our Audit Committee is deemed filed with the SEC or deemed incorporated by reference into any filing we make under the Securities Act or the Exchange Act, except to the extent we specifically incorporate it by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

We incorporate the response to this Item by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 16, 2009.

Item 13. Certain Relationships and Related Transactions and Director Independence.

We incorporate the response to this Item by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 16, 2009.

Item 14. Principal Accountant Fees and Services.

We incorporate the response to this Item by reference to our proxy statement to be filed with the SEC relating to our annual meeting of stockholders to be held April 16, 2009.

PART IV

Item 15. Exhibits and Financial Statement Schedule.

(a) Financial statements, financial statement schedule and exhibits filed:

(a) Consolidated Financial Statements

	<u>Page*</u>
Reports of Independent Registered Public Accounting Firm	38, 40
Donegal Group Inc. and Subsidiaries:	
Consolidated Balance Sheets as of December 31, 2008 and 2007	19
Consolidated Statements of Income and Comprehensive Income for each of the years in the three-year period ended December 31, 2008, 2007 and 2006	20
Consolidated Statements of Stockholders' Equity for each of the years in the three-year period ended December 31, 2008, 2007 and 2006	21
Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2008, 2007 and 2006	22
Notes to Consolidated Financial Statements	23
Report and Consent of Independent Registered Public Accounting Firm	Exhibit 23
(b) Financial Statement Schedule	
Donegal Group Inc. and Subsidiaries	<u>Page</u>
Schedule III — Supplementary Insurance Information	61

We have omitted all other schedules since they are not required, not applicable or the information is included in the financial statements or notes thereto.

* Refers to pages of our 2008 Annual Report to Stockholders. We incorporate by reference to pages 19 through 40 of our 2008 Annual Report to Stockholders our Consolidated Financial Statements, Notes to Consolidated Financial Statements, Report of Independent Registered Public Accounting Firm on consolidated financial statements,

Management's Report on Internal Control over Financial Reporting and Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting. With the exception of the portions of our 2008 Annual Report to Stockholders incorporated by reference in this Item and Items 5, 6, 7 and 8 of this Form 10-K Report, our 2008 Annual Report to Stockholders shall not be deemed filed as part of this Form 10-K Report or otherwise subject to the liabilities of Section 18 of the Exchange Act.

(c) Exhibits

Exhibit No.	Description of Exhibits	Reference
(3)(i)	Certificate of Incorporation of Donegal Group Inc., as amended.	(a)
(3)(ii)	Amended and Restated By-laws of Donegal Group Inc.	(r)
Management Contracts and Compensatory Plans or Arrangements		
(10)(B)	Donegal Group Inc. 2001 Equity Incentive Plan for Employees.	(c)
(10)(C)	Donegal Group Inc. 2001 Equity Incentive Plan for Directors.	(c)
(10)(D)	Donegal Group Inc. 2001 Employee Stock Purchase Plan, as amended.	(d)
(10)(E)	Donegal Group Inc. Amended and Restated 2001 Agency Stock Purchase Plan.	(e)
(10)(F)	Donegal Mutual Insurance Company 401(k) Plan.	(f)
(10)(G)	Amendment No. 1 effective January 1, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(f)
(10)(H)	Amendment No. 2 effective January 6, 2000 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(I)	Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(J)	Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(b)
(10)(K)	Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan.	(b)

Exhibit No.	Description of Exhibits	Reference
(10)(L)	Amendment No. 6 effective July 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan.	(p)
(10)(M)	Donegal Group Inc. 2007 Equity Incentive Plan for Employees.	(s)
(10)(N)	Donegal Group Inc. 2007 Equity Incentive Plan for Directors.	(s)
Other Material Contracts		
(10)(O)	Amended and Restated Tax Sharing Agreement dated as of October 19, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company and Peninsula Indemnity Company.	(p)
(10)(P)	Amended and Restated Services Allocation Agreement dated July 20, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Donegal Mutual Insurance Company.	(b)
(10)(Q)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(h)
(10)(R)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(i)
(10)(S)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(j)
(10)(T)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(k)

Exhibit No.	Description of Exhibits	Reference
(10)(U)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia.	(g)
(10)(V)	Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	(l)
(10)(W)	Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB.	(c)
(10)(X)	Plan of Conversion of Le Mars Mutual Insurance Company of Iowa adopted August 11, 2003	(n)
(10)(Y)	Stock Purchase Agreement dated as of October 28, 2003 between Donegal Group Inc. and Folksamerica Holding Company, Inc.	(m)
(10)(Z)	Credit Agreement dated as of November 25, 2003 between Donegal Group Inc. and Manufacturers and Traders Trust Company	(n)
(10)(AA)	First Amendment to Credit Agreement dated as of July 20, 2006 between Donegal Group Inc. and Manufacturers and Traders Trust Company	(b)
(10)(BB)	Amended and Restated Services Allocation Agreement dated October 19, 2006 among Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Donegal Mutual Insurance Company	(q)
(10)(CC)	Amendment dated as of February 11, 2008 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(v)
(10)(DD)	Contribution Note Purchase Agreement dated as of December 27, 2006 between Donegal Mutual Insurance Company and Sheboygan Falls Mutual Insurance Company	Filed herewith

<u>Exhibit No.</u>	<u>Description of Exhibits</u>	<u>Reference</u>
(10)(EE)	Plan of Conversion of Sheboygan Falls Mutual Insurance Company adopted October 14, 2008	Filed herewith
(13)	2008 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report).	Filed herewith
(14)	Code of Business Conduct and Ethics	(o)
(21)	Subsidiaries of Registrant.	Filed herewith
(23)	Report and Consent of Independent Registered Public Accounting Firm	Filed herewith
(31.1)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer	Filed herewith
(31.2)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer	Filed herewith
(32.1)	Section 1350 Certification of Chief Executive Officer	Filed herewith
(32.2)	Section 1350 Certification of Chief Financial Officer	Filed herewith

-
- (a) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-3 Registration Statement No. 333-59828 filed April 30, 2001.
- (b) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2001.
- (c) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2000.
- (d) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-62974 filed June 14, 2001.
- (e) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-63102 declared effective February 8, 2002.

- (f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1999.
- (g) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1996.
- (h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-1 Registration Statement No. 33-8533 declared effective October 29, 1986.
- (i) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1988.
- (j) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1992.
- (k) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.
- (l) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated May 31, 2000.
- (m) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 8-K Report dated November 3, 2003.
- (n) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 1, 2003.
- (o) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Annual Report for the year ended December 31, 2003.
- (p) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated October 23, 2006.
- (q) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-Q Quarterly Report for the quarter ended September 30, 2006.
- (r) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 22, 2006.
- (s) Such exhibit is hereby incorporated by reference to the like-numbered exhibit in Registrant's Form 8-K Report dated April 20, 2007.
- (t) Such exhibit is hereby incorporated by reference to the like-numbered exhibit in Registrant's Form 8-K Report dated March 1, 2008.

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.

DONEGAL GROUP INC.

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, President

Date: March 11, 2009

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Donald H. Nikolaus</u> Donald H. Nikolaus	President and a Director (principal executive officer)	March 11, 2009
<u>/s/ Jeffrey D. Miller</u> Jeffrey D. Miller	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	March 11, 2009
<u>/s/ Robert S. Bolinger</u> Robert S. Bolinger	Director	March 11, 2009
<u>/s/ Patricia A. Gilmartin</u> Patricia A. Gilmartin	Director	March 11, 2009

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Philip H. Glatfelter, II</u> Philip H. Glatfelter, II	Director	March 11, 2009
<u>/s/ John J. Lyons</u> John J. Lyons	Director	March 11, 2009
<u>/s/ Jon M. Mahan</u> Jon M. Mahan	Director	March 11, 2009
<u>/s/ S. Trezevant Moore, Jr.</u> S. Trezevant Moore, Jr.	Director	March 11, 2009
<u>R. Richard Sherbahn</u>	Director	March 11, 2009
<u>/s/ Richard D. Wampler, II</u> Richard D. Wampler, II	Director	March 11, 2009

DONEGAL GROUP INC. AND SUBSIDIARIES
SCHEDULE III — SUPPLEMENTARY INSURANCE INFORMATION
(\$ in thousands)

Years Ended December 31, 2008, 2007 and 2006

Segment	Net Earned Premiums	Net Investment Income	Net Losses And Loss Expenses	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Net Premiums Written
Year Ended						
December 31, 2008						
Personal lines	\$ 225,024	\$ —	\$ 155,573	\$ 37,821	\$ 34,482	\$ 239,540
Commercial lines	121,551	—	68,728	20,429	18,626	125,401
Investments	—	22,756	—	—	—	—
	<u>\$ 346,575</u>	<u>\$ 22,756</u>	<u>\$ 224,301</u>	<u>\$ 58,250</u>	<u>\$ 53,108</u>	<u>\$ 364,941</u>
Year Ended						
December 31, 2007						
Personal lines	\$ 196,429	\$ —	\$ 124,602	\$ 32,438	\$ 33,402	\$ 202,353
Commercial lines	113,642	—	53,182	18,767	19,324	111,336
Investments	—	22,785	—	—	—	—
	<u>\$ 310,071</u>	<u>\$ 22,785</u>	<u>\$ 177,784</u>	<u>\$ 51,205</u>	<u>\$ 52,726</u>	<u>\$ 313,689</u>
Year Ended						
December 31, 2006						
Personal lines	\$ 185,951	\$ —	\$ 112,924	\$ 29,973	\$ 30,822	\$ 192,980
Commercial lines	115,527	—	55,497	18,622	19,149	114,427
Investments	—	21,320	—	—	—	—
	<u>\$ 301,478</u>	<u>\$ 21,320</u>	<u>\$ 168,421</u>	<u>\$ 48,595</u>	<u>\$ 49,971</u>	<u>\$ 307,407</u>

DONEGAL GROUP INC. AND SUBSIDIARIES
SCHEDULE III — SUPPLEMENTARY INSURANCE INFORMATION, CONTINUED
(\$ in thousands)

Segment	At December 31,			
	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable
2008				
Personal lines	\$ 19,468	\$ 114,149	\$ 150,920	\$ —
Commercial lines	10,073	125,660	78,094	—
Investments	—	—	—	—
	<u>\$ 29,541</u>	<u>\$ 239,809</u>	<u>\$ 229,014</u>	<u>\$ —</u>
2007				
Personal lines	\$ 16,449	\$ 103,253	\$ 127,551	\$ —
Commercial lines	9,786	123,179	75,880	—
Investments	—	—	—	—
	<u>\$ 26,235</u>	<u>\$ 226,432</u>	<u>\$ 203,431</u>	<u>\$ —</u>

See accompanying Report and Consent of Independent Registered Public Accounting Firm.

CONTRIBUTION NOTE PURCHASE AGREEMENT

Between

DONEGAL MUTUAL INSURANCE COMPANY

and

SHEBOYGAN FALLS MUTUAL INSURANCE COMPANY

DATED AS OF DECEMBER 27, 2006

CONTENTS

	<u>Page</u>
RECITALS	1
I. DEFINITIONS	2
1.1 Definitions	2
II. SALE AND PURCHASE OF NOTE	8
2.1 Sale and Purchase of Note	8
2.2 Payment of Purchase Price and Delivery of Note	9
2.3 Closing Date	9
III. REPRESENTATIONS AND WARRANTIES OF SHEBOYGAN FALLS	10
3.1 Organization and Standing	10
3.2 Subsidiaries	10
3.3 Authorization	10
3.4 Financial Statements; Examinations	11
3.5 Material Changes Since December 31, 2005	12
3.6 Availability of Assets and Legality of Use	12
3.7 Title to Property	12
3.8 Books and Records	12
3.9 Accounts Receivable	13
3.10 Compliance with Legal Requirements; Governmental Authorizations	13
3.11 Real Property and Leases	14
3.12 Insurance	14
3.13 Conduct of Business	15
3.14 No Undisclosed Material Liabilities	16
3.15 No Defaults or Litigation	16
3.16 Tax Liabilities	16
3.17 Contracts	16
3.18 Employee Agreements	17
3.19 Employee Relations	18
3.20 Employee Retirement Income Security Act	18
3.21 Conflicts; Sensitive Payments	19
3.22 Corporate Name	19
3.23 Trademarks and Proprietary Rights	19
3.24 Environmental Matters	19
3.25 Insurance Issued by Sheboygan Falls	20
3.26 Health and Safety Matters	21
3.27 No Omissions	21
3.28 Finders	22
3.29 Representations and Warranties to Be True on the Closing Date	22

	<u>Page</u>
IV. REPRESENTATIONS AND WARRANTIES OF DONEGAL MUTUAL	22
4.1 Organization and Standing	22
4.2 Authorization	22
4.3 Consents and Approvals of Government Agencies	23
4.4 Transferability	23
4.5 No Omissions	24
4.6 Finders	24
4.7 Representations and Warranties to be True on the Closing Date	24
V. CERTAIN COVENANTS	24
5.1 Investigation of Sheboygan Falls and Donegal Mutual	24
5.2 Confidential Nature of Information	25
5.3 Preserve Accuracy of Representations and Warranties	25
5.4 Maintain Sheboygan Falls As a Going Concern	26
5.5 Make No Material Change in Sheboygan Falls	26
5.6 No Public Announcement	27
5.7 Required Filings	27
5.8 No Solicitation	27
5.9 Future Actions Regarding Sheboygan Falls	28
5.10 Affirmative Covenants of Sheboygan Falls	31
5.11 Negative Covenants of Sheboygan Falls	32
VI. CONDITIONS	33
6.1 Conditions to Each Party's Obligations	33
6.2 Conditions to Obligations of Donegal Mutual	33
6.3 Conditions to Obligations of Sheboygan Falls	35
VII. TERMINATION	37
7.1 Termination	37
7.2 Effect of Termination	38
VIII. AMENDMENT, WAIVER AND INDEMNIFICATION	38
8.1 Amendment	38
8.2 Extension; Waiver	38
8.3 Survival of Obligations	39
8.4 Indemnification	39
IX. MISCELLANEOUS	41
9.1 Notices	41
9.2 Expenses	42
9.3 Governing Law	43
9.4 Successors and Assigns	43
9.5 Partial Invalidity	43
9.6 Execution in Counterparts	43

9.7	Titles and Headings	<u>Page</u> 43
9.8	Entire Agreement; Statements as Representations	43
9.9	Specific Performance	43

SIGNATURES		44
------------	--	----

APPENDICES:

APPENDIX A	—	Form of Contribution Note	A-1
APPENDIX B	—	Form of Services Agreement	B-1
APPENDIX C	—	Form of Amended and Restated Bylaws of Sheboygan Falls Mutual Insurance Company	C-1
APPENDIX D-1	—	Form of Employment Agreement for Lee F. Wilcox	D-1
APPENDIX D-2	—	Form of Employment Agreement for Executive Officers of Sheboygan Falls other than Lee F. Wilcox	D-2
APPENDIX E	—	Form of Technology License Agreement.	E-1
APPENDIX F	—	Form of Retrocessional Reinsurance Agreement	F-1

CONTRIBUTION NOTE PURCHASE AGREEMENT

THIS CONTRIBUTION NOTE PURCHASE AGREEMENT (this "Agreement") made as of this 27th day of December, 2006 between DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company ("Donegal Mutual") and SHEBOYGAN FALLS MUTUAL INSURANCE COMPANY, a Wisconsin mutual fire and casualty insurance company ("Sheboygan Falls").

WITNESSETH:

WHEREAS, Sheboygan Falls proposes to issue a contribution note (the "Note"), the repayment of which would be subordinated to the claims of policyholders of Sheboygan Falls and otherwise be in compliance with applicable provisions of the Wisconsin Insurance Code and the regulations of the Commissioner of Insurance of the State of Wisconsin, in the principal amount of Three Million Five Hundred Thousand Dollars (\$3,500,000) in substantially the form of Appendix A;

WHEREAS, Donegal Mutual proposes to purchase the Note;

WHEREAS, Donegal Mutual and Sheboygan Falls propose that Sheboygan Falls will (i) make certain changes in the composition of the Board of Directors of Sheboygan Falls in connection with the transactions contemplated by this Agreement, (ii) adopt Amended and Restated Bylaws in substantially the form of Appendix C and (iii) enter into employment agreements with four of its executive officers in substantially the form of Appendices D-1 and D-2;

WHEREAS, Donegal Mutual and Sheboygan Falls propose that Donegal Mutual and Sheboygan Falls enter into: (i) a Services Agreement in substantially the form of Appendix B whereby Donegal Mutual will provide the services specified therein to Sheboygan Falls in accordance with the terms of such Agreement, (ii) a Technology License Agreement in substantially the form of Appendix E whereby Donegal Mutual will license certain of its computer applications and systems to Sheboygan Falls in accordance with the terms of such Agreement and (iii) a Retrocessional Reinsurance Agreement in substantially the form of Appendix F, whereby Sheboygan Falls will cede all of its business to Donegal Mutual and Donegal Mutual will retrocede all of such business to Sheboygan Falls in accordance with the terms of such Agreement;

WHEREAS, the Board of Directors of Donegal Mutual has approved this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement by resolutions duly adopted; and

WHEREAS, the Board of Directors of Sheboygan Falls has approved this Agreement, the Note, the Services Agreement, the Technology License Agreement, the Retrocessional Reinsurance Agreement, the Amended and Restated Bylaws and the Employment Agreements by resolutions duly adopted;

NOW, THEREFORE, in consideration of the mutual covenants set forth herein and intending to be legally bound hereby, Donegal Mutual and Sheboygan Falls agree as follows:

ARTICLE I
DEFINITIONS

1.1 Definitions. When used in this Agreement, the following words or phrases have the following meanings:

“Affiliate” shall mean a Person that directly, or indirectly through one or more intermediaries, controls, is controlled by or is under common control with another Person or beneficially owns or has the power to vote or direct the vote of 10% or more of any class of voting stock or of any form of voting equity interest of such other Person in the case of a Person that is not a corporation. For purposes of this definition, “control”, including the terms “controlling” and “controlled”, means the power to direct or cause the direction of the management and policies of a Person, directly or indirectly, whether through the ownership of securities or partnership or other ownership interests, by contract or otherwise.

“Agreement” shall have the meaning ascribed to it in the preamble.

“Ancillary Documents” shall mean the Note, the Services Agreement, the Employment Agreements, the Technology License Agreement and the Retrocessional Reinsurance Agreement.

“Amended and Restated Bylaws” shall mean the Amended and Restated Bylaws of Sheboygan Falls in substantially the form of Appendix C.

“Annual Statements” shall mean the annual statements of condition and affairs filed pursuant to the Wisconsin Insurance Code.

“Assets” shall mean all rights, titles, franchises and interests in and to every species of property, real, personal and mixed, tangible and intangible, and things in action relating thereto, including, without limitation, cash and cash equivalents, securities, including, without limitation, exempted securities under the Securities Act of 1933, as amended (the “Securities Act”), receivables, recoverables from reinsurance and otherwise, deposits and advances, loans, agents balances, real property, together with buildings, structures and the improvements thereon, fixtures contained therein and appurtenances thereto and easements

and other rights relating thereto, machinery, equipment, furniture, fixtures, leasehold improvements, vehicles and other assets or property, leases, licenses, permits, approvals, authorizations, joint venture agreements, contracts or commitments, whether written or oral, policy forms, training materials, underwriting manuals, lists of policyholders and agents, processes, trade secrets, know-how, computer software, computer programs and source codes, protected formulae, all other Intellectual Property, research, goodwill, prepaid expenses, books of account, records, files, invoices, data, rights, claims and privileges and any other assets whatsoever.

“Closing” and “Closing Date” shall have the respective meanings set forth in Section 2.3.

“Code” shall mean the Internal Revenue Code of 1986, as amended.

“Commissioner of Insurance” shall mean the Commissioner of Insurance of the State of Wisconsin.

“Condition” shall mean, as to a Person, the financial condition, business, results of operations, prospects, liabilities and/or properties or other Assets of such Person.

“Contract” shall mean a contract, indenture, bond, note, mortgage, deed of trust, lease, agreement or commitment, whether written or oral, including, without limitation, an Insurance Contract.

“Disclosure Schedule” or “Schedule” shall mean the Schedules attached to this Agreement.

“Donegal Mutual” shall have the meaning ascribed to it in the preamble.

“Donegal Mutual Adverse Effect” shall mean a material adverse effect on the Condition of Donegal Mutual, taken as a whole, other than resulting from general economic or financial conditions that do not affect Donegal Mutual uniquely.

“Donegal Mutual Property” shall mean any property on which Donegal Mutual holds a Lien or any facility that is owned by Donegal Mutual or in the management of which Donegal Mutual actively participates.

“Employment Agreements” shall mean the Employment Agreements to be entered into between Sheboygan Falls and Lee F. Wilcox in substantially the form of Appendix D-1 and between Sheboygan Falls and each of Bradford C. Bailey, Daniel A. Kussart and Janice L. Tupper in substantially the form of Appendix D-2.

“Employee Welfare Plan” shall have the meaning set forth in Section 3(1) of ERISA.

“Environmental Claim” shall mean any written notice by a Person alleging actual or potential Liability, including, without limitation, potential Liability for any investigatory cost, cleanup cost, governmental response cost, natural resources damage, property damage, personal injury or penalty, arising out of, based on or resulting from (a) the presence, transport, disposal, discharge or release, of any Hazardous Materials at any location, whether or not owned by Sheboygan Falls, as the case may be, or (b) circumstances forming the basis of any violation or alleged violation of any Environmental Law.

“Environmental Law” shall mean all federal, state, local and foreign Laws relating to pollution or protection of human health or the environment, including, without limitation, ambient air, surface water, ground water, land surface or subsurface strata, including, without limitation, Laws relating to emissions, discharges, releases or threatened releases, or the presence of Hazardous Materials, or otherwise relating to the manufacture, processing, distribution, use, existence, treatment, storage, disposal, transport, recycling, reporting or handling of Hazardous Materials.

“ERISA” shall mean the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations promulgated thereunder.

“ERISA Affiliate” shall mean, with respect to Sheboygan Falls, any trade or business that together with Sheboygan Falls would be deemed a “single employer” within the meaning of Section 4001(a)(14) of ERISA.

“Existing Confidentiality Agreements” shall mean the Confidentiality Agreements between Sheboygan Falls and Donegal Mutual dated as of January 11, 2006 and October 31, 2006.

“Governmental Entity” shall mean a court, legislature, governmental agency, commission or administrative or regulatory authority or instrumentality, domestic or foreign.

“Hazardous Materials” shall mean any (i) “hazardous substance,” “pollutants,” or “containment” as defined in Sections 101(14) and (33) of the United States Comprehensive Environmental Response, Compensation and Liability Act, as amended (“CERCLA”) or the regulations issued pursuant to Section 102 of CERCLA; (ii) substance that is or may be designated pursuant to Section 311(b)(2)(A) of the Federal Water Pollution Control Act, as amended (“FWCPA”); (iii) hazardous waste having the characteristics identified under or listed pursuant to Section 3001 of the Resource Conservation and Recovery Act, as amended (“RCRA”) or having the characteristics that may subsequently be considered under RCRA to constitute a hazardous waste; (iv) substance containing petroleum, as that term is defined in Section 9001(8) of RCRA; (v) toxic pollutant that is or may be listed under Section 307(a) of FWCPA; (vi) hazardous air pollutant that is or may be listed under Section 112 of the Clean Air Act, as amended; (vii) imminently

hazardous chemical substance or mixture with respect to which action has been or may be taken pursuant to Section 7 of the Toxic Substance Control Act, as amended; (viii) source, special nuclear or by-product material as defined by the Atomic Energy Act of 1954, as amended; (ix) asbestos-containing material, or urea formaldehyde or material that contains it; (x) waste oil and other petroleum products and (xi) any other toxic materials, contaminants or hazardous substances or wastes pursuant to any Environmental Law.

“Health and Safety Requirements” shall mean all federal, state, local and foreign statutes, regulations, ordinances and other provisions having the force and effect of Law, all judicial and administrative orders and determinations, all contractual obligations and all common law concerning public health and safety, worker health and safety, including without limitation those relating to the presence, use, production, generation, handling, transportation, treatment, storage, disposal, labeling, testing, processing, discharge, release, threatened release, control or cleanup of any hazardous materials, substances or wastes, chemical substances or mixtures, pesticides, pollutants, contaminants, toxic chemicals, petroleum products or byproducts, asbestos, polychlorinated biphenyls or noise, each as amended and as now or hereafter in effect.

“Insurance Contract” shall mean any Contract of insurance including, without limitation, reinsurance contracts issued by Sheboygan Falls.

“Insurance License” shall mean a License granted by a Governmental Entity to transact an insurance or reinsurance business.

“Intellectual Property” shall mean (i) all inventions whether patentable or unpatentable and whether or not reduced to practice, all improvements thereof and all patents, applications and patent disclosures, together with all reissuance, continuations, continuations-in-part, revisions, extensions and reexaminations thereof; (ii) all trademarks, service marks, trade dress, logos, trade names and corporate names, together with all translations, adaptations, derivations and applications, registrations and renewals in connection therewith; (iii) all copyrightable works, all copyrights and all applications, registrations and renewals in connection therewith; (iv) all mask works and all applications, registrations and renewals thereof; (v) all trade secrets and confidential business information including ideas, research and development, know-how, formulas, data, designs, drawings, specifications, policy forms, training materials, underwriting manuals, pricing and cost information and business and marketing plans and proposals; (vi) all computer software including data and related documentation; (vii) all other proprietary rights and (viii) all copies and tangible embodiments thereof in whatever form or medium.

“Investment Assets” shall mean bonds, notes, debentures, mortgage loans, collateral loans and all other instruments of indebtedness, stocks, partnership interests and other equity interests, real estate and leasehold and other interests therein, certificates issued by or

interests in trusts, cash on hand and on deposit, personal property and interests therein and all other Assets acquired for investment purposes.

“IRS” shall mean the Internal Revenue Service.

“Knowledge” shall mean the knowledge of the relevant Person, after due inquiry by its appropriate officer or officers.

“Law” shall mean a law, ordinance, rule or regulation enacted or promulgated, or an Order issued or rendered, by any Governmental Entity.

“Liability” shall mean a liability, obligation, claim or cause of action of any kind or nature whatsoever, whether absolute, accrued, contingent or other and whether known or unknown, including, without limitation, any liability, obligation, claim or cause of action arising as a result of an Insurance Contract.

“License” shall mean a license, certificate of authority, permit or other authorization to transact an activity or business issued or granted by a Governmental Entity.

“Lien” shall mean a lien, mortgage, deed to secure debt, pledge, security interest, lease, sublease, charge, levy or other encumbrance of any kind.

“Losses” shall mean losses, claims, damages, costs, expenses, Liabilities and judgments, including, without limitation, court costs and attorneys’ and expert witness fees.

“Note” shall mean the Contribution Note to be issued by Sheboygan Falls to Donegal Mutual in substantially the form of Appendix A.

“OCI” shall mean the Office of the Commissioner of Insurance of the State of Wisconsin.

“Officers’ Certificate” shall mean, with respect to any Person, a certificate executed by the Chief Executive Officer, the President or an appropriate Vice President of such Person, as attested by the Secretary or an Assistant Secretary of such Person.

“Ordinary Course of Business” shall mean an action taken by a Person if: (i) such action is consistent with the past practices of such Person and is taken in the ordinary course of the normal day-to-day operations of such Person; (ii) such action is not required to be authorized by the board of directors of such Person or by any Person or group of Persons exercising similar authority or by a parent company and (iii) such action is similar in nature and magnitude to actions customarily taken, without any authorization by the board of directors or by any Person or group of Persons exercising similar authority or by a parent company, in the ordinary course of the normal day-to-day operations of other Persons that are in the same line of business as such Person.

“Order” shall mean an order, writ, ruling, judgment, injunction or decree of, or any stipulation to or agreement with, any arbitrator, mediator or Governmental Entity.

“PBGC” shall mean the Pension Benefit Guaranty Corporation or any successor entity.

“Permits” shall have the meaning set forth in Section 3.10(d).

“Permitted Liens” shall mean as to Sheboygan Falls, (i) all Liens approved in writing by Donegal Mutual, (ii) statutory Liens arising out of operation of Law with respect to a Liability incurred in the Ordinary Course of Business of Sheboygan Falls and that is not delinquent and can be paid without interest or penalty and (iii) such Liens and other imperfections of title that do not materially detract from the value or impair the use of the property subject thereto.

“Person” shall mean an individual, corporation, partnership, association, joint stock company, Governmental Entity, business trust, unincorporated organization or other legal entity.

“Proceedings” shall mean actions, suits, hearings, claims and other similar proceedings.

“Quarterly Statements” shall mean the quarterly statements of condition and affairs filed pursuant to state insurance Laws.

“Reorganization Proposal” shall have the meaning set forth in Section 5.8.

“Required Filings and Approvals” shall mean the filing of this Agreement with and the approval of such by the Commissioner of Insurance, and such other applications, registrations, declarations, filings, authorizations, Orders, consents and approvals as may be required to be made or obtained prior to consummation of the transactions contemplated hereby under the Laws of any jurisdiction.

“Retrocessional Reinsurance Agreement” shall mean the Retrocessional Reinsurance Agreement between Donegal Mutual and Sheboygan Falls in substantially the form of Appendix F.

“SAP” shall mean statutory accounting practices as prescribed or permitted by the Commissioner of Insurance and the National Association of Insurance Commissioners subject, in the case of unaudited interim financial statements, to normal year-end adjustments and the absence of footnotes.

“Sanders” shall mean Sanders Morris Harris, Inc.

“Services Agreement” shall mean the Services Agreement between Donegal Mutual and Sheboygan Falls in substantially the form of Appendix B.

“Sheboygan Falls” shall have the meaning ascribed to it in the preamble.

“Sheboygan Falls Adverse Effect” shall mean a material adverse effect on the Condition of Sheboygan Falls, taken as a whole, other than resulting from general economic or financial conditions that do not affect Sheboygan Falls uniquely.

“Sheboygan Falls Financial Statements” shall have the meaning set forth in Section 3.4.

“Sheboygan Falls Property” shall mean any property on which Sheboygan Falls holds a Lien or any facility that is owned by Sheboygan Falls or in the management of which Sheboygan Falls actively participates.

“Subsidiary” of a Person means any Person with respect to whom such specified Person, directly or indirectly, beneficially owns 50% or more of the equity interests in, or holds the voting control of 50% or more of the equity interests in, such Person.

“Taxes” shall mean all income, gross income, gross receipts, premium, sales, use, transfer, franchise, profits, withholding, payroll, employment, excise, severance, property and windfall profits taxes, and all other taxes, assessments or similar charges of any kind whatsoever thereon or applicable thereto, together with any interest and any penalties, additions to tax or additional amounts, in each case imposed by any taxing authority, domestic or foreign, upon Sheboygan Falls, including, without limitation, all such amounts imposed as a result of being a member of an affiliated or combined group.

“Tax Returns” or “Returns” shall mean all tax returns, declarations, reports, estimates, information returns and statements required to be filed under federal, state, local or foreign Laws.

“Technology License Agreement” shall mean the Technology License Agreement between Donegal Mutual and Sheboygan Falls in substantially the form of Appendix E.

“Wisconsin Insurance Code” shall mean Chapters 611 and 617 of the Wisconsin Insurance Code, as amended, and the regulations promulgated thereunder.

ARTICLE II

SALE AND PURCHASE OF NOTE

2.1 Sale and Purchase of Note. Upon the terms, conditions, representations and warranties herein set forth, Sheboygan Falls hereby agrees to sell the Note to Donegal Mutual and Donegal Mutual hereby agrees to purchase the Note from Sheboygan Falls.

2.2 Payment of Purchase Price and Delivery of Note. The purchase price of the Note shall be Three Million Five Hundred Thousand Dollars (\$3,500,000). The entire purchase price of the Note is to be paid in cash by Donegal Mutual to Sheboygan Falls on the Closing Date against delivery of the Note.

2.3 Closing Date.

(a) Subject to the fulfillment of the conditions precedent specified in Article VI, the transactions contemplated by this Agreement shall be consummated (the "Closing") at 10:00 a.m. on the second business day following the date on which all of the conditions set forth in Article VI shall have been fulfilled (the "Closing Date"). Unless otherwise mutually agreed by Donegal Mutual and Sheboygan Falls, the Closing shall be held at the offices of Foley & Lardner LLP, 150 East Gilman, Madison, Wisconsin 53703.

(b) At the Closing, Sheboygan Falls shall deliver to Donegal Mutual (i) copies of each resolution adopted by the Board of Directors of Sheboygan Falls approving and adopting this Agreement, the Note, the Services Agreement, the Employment Agreements, the Technology License Agreement, the Retrocessional Reinsurance Agreement and the Amended and Restated Bylaws and authorizing the consummation of the transactions contemplated hereby and thereby, certified by the Secretary of Sheboygan Falls that each such resolution is then in full force and effect and without amendment; (ii) any Officers' Certificates specified in Section 6.2 duly executed by Sheboygan Falls; (iii) the Services Agreement duly executed by Sheboygan Falls; (iv) the Technology License Agreement duly executed by Sheboygan Falls; (v) the Retrocessional Reinsurance Agreement duly executed by Sheboygan Falls; (vi) the Note duly executed by Sheboygan Falls; (vii) duly executed copies of the resignations of four current members of the Board of Directors of Sheboygan Falls designated by Sheboygan Falls and evidence of the election of six designees of Donegal Mutual to Sheboygan Falls' Board of Directors as specified in Section 6.2(d); (viii) evidence of the termination of any severance or similar agreement required by Section 6.2(e) and (ix) duly executed copies of the Employment Agreements as specified in Section 6.2(e).

(c) At the Closing, Donegal Mutual shall deliver to Sheboygan Falls (i) copies of each resolution adopted by the Board of Directors of Donegal Mutual approving and adopting this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement and authorizing the consummation of the transactions contemplated hereby and thereby, certified by the Secretary of Donegal Mutual that each such resolution is then in full force and effect and without amendment; (ii) the Services Agreement duly executed by Donegal Mutual; (iii) the Technology License Agreement duly executed by Donegal Mutual; (iv) the Retrocessional Reinsurance Agreement duly executed by Donegal Mutual and (v) any Officers' Certificate specified in Section 6.3 duly executed by Donegal Mutual.

ARTICLE III

REPRESENTATIONS AND WARRANTIES OF SHEBOYGAN FALLS

As an inducement to Donegal Mutual to enter into this Agreement and to consummate the transactions contemplated herein, Sheboygan Falls represents and warrants to Donegal Mutual and agrees as follows:

3.1 Organization and Standing.

(a) Sheboygan Falls is a mutual fire and casualty insurance company duly organized, validly existing and in good standing under the laws of the State of Wisconsin. Sheboygan Falls is not admitted to transact an insurance business as a foreign insurance company in any state.

(b) Sheboygan Falls has the corporate power and authority and other authorizations necessary or required in order for it to own or lease and operate the Sheboygan Falls Property and to carry on its business as now conducted.

3.2 Subsidiaries. Sheboygan Falls has no subsidiaries.

3.3 Authorization. Sheboygan Falls has the requisite corporate power and authority to execute and deliver this Agreement and the Ancillary Documents, and to adopt the Amended and Restated Bylaws and to consummate the transactions contemplated hereby and thereby. The execution and delivery of this Agreement, the Note, the Services Agreement, the Employment Agreements, the Technology License Agreement and the Retrocessional Reinsurance Agreement, the consummation of the transactions contemplated hereby and thereby and the adoption of the Amended and Restated Bylaws (which Amended and Restated Bylaws are subject to the approval of the OCI) have been duly approved and authorized by the Board of Directors of Sheboygan Falls. No other corporate proceedings on the part of Sheboygan Falls are necessary to authorize this Agreement, the Note, the Services Agreement, the Employment Agreements, the Technology License Agreement and the Retrocessional Reinsurance Agreement and the transactions contemplated hereby and thereby and the adoption of the Amended and Restated Bylaws. This Agreement, and the Ancillary Documents, when executed and delivered by Sheboygan Falls and assuming the due execution thereof by the other parties thereto, will constitute the valid, legal and binding agreements of Sheboygan Falls enforceable in accordance with their respective terms, except that (i) such enforcement may be subject to bankruptcy, rehabilitation, liquidation, conservation, dissolution, insolvency, reorganization, moratorium or other similar Laws now or hereafter in effect relating to creditors' rights generally and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any Proceeding therefor may be brought. Neither the execution nor the delivery of this Agreement or the Ancillary

Documents or the adoption of the Amended and Restated Bylaws nor the consummation of the transactions contemplated hereby or thereby, nor compliance with nor fulfillment of the terms and provisions hereof or thereof, will (i) conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under the Restated Articles of Incorporation or the Amended and Restated Bylaws of Sheboygan Falls, or any instrument, agreement, mortgage, judgment, Order, award, decree or other restriction to which Sheboygan Falls is a party; (ii) give any party to or with rights under any such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction the right to terminate, modify or otherwise change the rights or obligations of Sheboygan Falls under such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction or (iii) require the approval, consent or authorization of or any filing with or notification to any federal, state or local court or Governmental Entity, except (y) the Required Filings and Approvals and (z) any approval, consent or authorization the failure of which to obtain would not, individually or in the aggregate, have a Sheboygan Falls Adverse Effect.

3.4 Financial Statements; Examinations.

(a) Sheboygan Falls has furnished to Donegal Mutual the balance sheets of Sheboygan Falls as of December 31, 2003, 2004 and 2005 and the related statements of operations and of changes in financial position for the periods then ended, together with appropriate notes to such financial statements (collectively, the "Sheboygan Falls Financial Statements"). Sheboygan Falls will furnish to Donegal Mutual, if available prior to Closing, the balance sheet of Sheboygan Falls as of December 31, 2006 and the related statements of operations and of changes in financial position for the period then ended, together with appropriate notes to such financial statements, which shall also constitute "Sheboygan Falls Financial Statements." The Sheboygan Falls Financial Statements are accompanied by the reports thereon by Dippold & Associates, LLC, independent certified public accountants. The Sheboygan Falls Financial Statements are correct and complete in all material respects and fairly present the financial position of Sheboygan Falls as at the respective dates thereof, the results of its operations and the changes in its financial position for the respective periods covered thereby and have been prepared in conformity with SAP consistently applied throughout all periods.

(b) Each of the Annual Statements for 2003, 2004 and 2005 and, if available, for 2006 was or will be in compliance in all material respects with applicable Law when filed.

(c) The most recently completed report of examination of Sheboygan Falls conducted by the OCI was for the period set forth in Schedule 3.4(C), and a complete and correct copy of such report is attached to Schedule 3.4(C).

(d) Since the dates of all examinations referred to in Schedule 3.4(C), Sheboygan Falls has not been the subject of further examination by any insurance

Governmental Entity, and Sheboygan Falls is not currently undergoing examination by any insurance Governmental Entity.

(e) Schedule 3.4(E) sets forth a correct and complete list of all (i) accounts, borrowing resolutions and deposit boxes maintained by Sheboygan Falls at any bank or other financial institution, (ii) the names of the persons authorized to sign or otherwise act with respect thereto and (iii) powers of attorney for Sheboygan Falls with respect thereto.

3.5 Material Changes Since December 31, 2005. Since December 31, 2005, the business of Sheboygan Falls has been operated only in the ordinary course and, whether or not in the Ordinary Course of Business of Sheboygan Falls, other than as disclosed in this Agreement or the Schedules referred to herein, there has not been, occurred or arisen (i) any material adverse change in the Condition of Sheboygan Falls from that shown on the balance sheet of Sheboygan Falls as of December 31, 2005 referred to in Section 3.4; (ii) any damage or destruction in the nature of a casualty loss, whether covered by insurance or not, to any Asset that is material to the financial condition, operations or business of Sheboygan Falls; (iii) any material increase in any employee benefit plan listed in Section 3.18; (iv) any amendment or termination of any agreement, or cancellation or reduction of any debt owing to Sheboygan Falls or waiver or relinquishment of any right of material value to Sheboygan Falls or (v) any other event, condition or state of facts of any character that would constitute a Sheboygan Falls Adverse Effect.

3.6 Availability of Assets and Legality of Use. The Assets owned or leased by Sheboygan Falls constitute all of the Assets that are being used in its business, and such Assets, to the Knowledge of Sheboygan Falls, are in good and serviceable condition, normal wear and tear excepted, and suitable and adequate for the uses for which intended and such Assets and their uses conform in all material respects to all applicable Laws. Such Assets will be sufficient for the continued conduct of Sheboygan Falls' business immediately after the Closing in substantially the same manner as Sheboygan Falls' business was conducted immediately prior to the Closing.

3.7 Title to Property. Sheboygan Falls has good and marketable title to all of its Assets, including the Assets reflected on the December 31, 2005 balance sheet referred to in Section 3.4 and all of the Assets thereafter acquired by it, except to the extent that such Assets have thereafter been disposed of for fair value in the Ordinary Course of Business of Sheboygan Falls.

3.8 Books and Records. The books of account, minute books and other records of Sheboygan Falls, all of which have been made available to Donegal Mutual, are complete and correct and have been maintained in accordance with sound business practices and the requirements of the Wisconsin Insurance Code and any other applicable Laws, including the maintenance of an adequate system of internal controls. Since January 1, 2001, the minute books of Sheboygan Falls contain accurate and complete records of all meetings held of, and

corporate action taken by, the policyholders, the Board of Directors and committees of the Board of Directors of Sheboygan Falls, and no meeting of any such policyholders, Board of Directors or committees thereof has been held for which minutes have not been prepared and are not contained in such minute books. At the Closing, all of the aforementioned books and records will be in the possession of Sheboygan Falls.

3.9 Accounts Receivable. All accounts receivable reflected on the December 31, 2005 balance sheet referred to in Section 3.4 and all accounts receivable arising subsequent to such date and prior to the date hereof, not collected at the date hereof, have arisen from bona fide transactions in the Ordinary Course of Business of Sheboygan Falls. To the Knowledge of Sheboygan Falls, none of such receivables is subject to counterclaims or set-offs or is in dispute and all of such accounts are good and collectible in the Ordinary Course of Business at the aggregate recorded amounts thereof, subject in each case to the allowance for possible losses shown on such balance sheet. All accounts receivable existing on the Closing Date will be good and collectible in the Ordinary Course of Business at the aggregate recorded amounts thereof, net of any applicable allowance for doubtful accounts, which allowance will be determined on a basis consistent with the basis used in determining the allowance for doubtful accounts reflected in the December 31, 2005 balance sheet referred to in Section 3.4.

3.10 Compliance with Legal Requirements; Governmental Authorizations. Schedule 3.10 contains a complete and accurate list and copy of its license to transact insurance in Wisconsin and each other material license, permit and other authorization held by Sheboygan Falls in the operation of its business. Except as set forth in Schedule 3.10:

(a) To the Knowledge of Sheboygan Falls, Sheboygan Falls is, and at all times since January 1, 2001 has been, in compliance in all material respects with the Wisconsin Insurance Law, and all other Laws that are applicable to it or to the conduct or operation of its business or the ownership or use of any of its Assets.

(b) To the Knowledge of Sheboygan Falls, no event has occurred or circumstance exists that with or without notice or lapse of time (i) may constitute or result in a violation by Sheboygan Falls of, or a failure on the part of Sheboygan Falls to comply with, any Law in any material respect or (ii) may give rise to any material obligation on the part of Sheboygan Falls to undertake, or to bear all or any portion of the cost of, any remedial action of any nature.

(c) Sheboygan Falls has not received, at any time since January 1, 2001, any oral or written notice or other communication from any Governmental Entity or any other Person regarding (i) any actual, alleged, possible or potential violation of, or failure to comply with, any Law in any material respect or (ii) any actual, alleged, possible or potential material obligation that may give rise on the part of Sheboygan Falls to undertake, or to bear all or any portion of the cost of, any material remedial action of any nature.

(d) Sheboygan Falls possesses all material licenses, permits and other authorizations necessary to own or lease and operate its properties and to conduct its business as now conducted and each of Sheboygan Falls' agents is duly licensed as such. All of such licenses, permits and authorizations of Sheboygan Falls and such agents' appointments are hereinafter collectively called the "Permits." All Permits are in full force and effect and will continue in effect after the date hereof and the Closing Date without the consent, approval or act of, or the making of any filing with, any Governmental Entity other than the Required Filings and Approvals. To the Knowledge of Sheboygan Falls, Sheboygan Falls is, and at all times since January 1, 2001 has been, in material compliance with all terms and requirements of each Permit. Neither Sheboygan Falls nor, to the Knowledge of Sheboygan Falls, any of Sheboygan Falls' agents is in material violation of the terms of any Permit, and Sheboygan Falls has not received notice of any violation or claimed violation thereunder. All applications required to have been filed for the renewal of any and all Permits have been duly filed on a timely basis with the appropriate Governmental Entity, and all other filings required to have been made with such Governmental Entities with respect to the Permits have been duly made on a timely basis.

3.11 Real Property and Leases. Except as described on Schedule 3.11(A), Sheboygan Falls does not own any real property, nor is Sheboygan Falls a party to any lease or agreement under which Sheboygan Falls is lessee or sublessee of, or holds or operates, any real property owned by any third party. All of such leases and agreements are in full force and effect and constitute legal, valid and binding obligations of Sheboygan Falls, and, to the Knowledge of Sheboygan Falls, the other parties thereto. Sheboygan Falls is not in default in any material respect under any such lease or agreement nor has any event occurred that, with the passage of time or giving of notice or both would constitute such a default and Sheboygan Falls will not take any action or fail to take required action between the date hereof and the Closing Date that would permit any such default or event to occur. None of such leases and agreements requires the consent of any party thereto in order to undertake or consummate the transactions contemplated by this Agreement.

3.12 Insurance. Sheboygan Falls maintains policies of fire and casualty, product and other liability and other forms of insurance in such amounts and against such risks and losses as are adequate and reasonable for its business as currently conducted and properties and are sufficient for compliance with all Laws applicable to Sheboygan Falls. All such policies are valid, duly issued and enforceable in accordance with their respective terms and conditions. Attached as Schedule 3.12 is a list and an accurate description of all policies of insurance that are or were owned, held or maintained by or for the benefit of Sheboygan Falls or under which Sheboygan Falls is or was a named insured from January 1, 2001 to the date hereof, including policy numbers, nature of coverage, limits, deductibles, carriers, premiums and effective and termination dates, under which Sheboygan Falls has any remaining coverage. To the Knowledge of Sheboygan Falls, Sheboygan Falls has complied with each of such policies and has not failed to give any notice or present any known claim thereunder.

Sheboygan Falls will keep such insurance in full force and effect through the Closing Date. Sheboygan Falls has not received, and, to the Knowledge of Sheboygan Falls, no event or omission has occurred that may cause it to receive, notice that any such policies will be cancelled or will be reduced in amount or scope. True and complete copies of all such policies have been delivered to Donegal Mutual.

3.13 Conduct of Business.

(a) Schedule 3.13 lists all claims arising in other than the Ordinary Course of Business of Sheboygan Falls that are pending or, to the Knowledge of Sheboygan Falls, threatened against Sheboygan Falls and correctly sets forth the data reflected therein, including the insurance carrier to which the claim has been reported. No insurance carrier listed therein has denied coverage of any claim listed opposite its name or accepted investigation of any such loss or defense of any such claim under a reservation of rights.

(b) The aggregate actuarial reserves and other actuarial amounts held in respect of Liabilities with respect to Insurance Contracts of Sheboygan Falls as established or reflected in the December 31, 2005 Annual Statement of Sheboygan Falls and in the Sheboygan Falls Financial Statements as of December 31, 2005: (i) were or will be determined in accordance with sound actuarial standards consistently applied, (ii) were or will be fairly stated in accordance with sound actuarial principles, (iii) were or will be based on actuarial assumptions that are in accordance with those specified in the related Insurance Contracts, (iv) met or will meet the requirements of the insurance Laws of the applicable jurisdiction in all material respects and (v) to the Knowledge of Sheboygan Falls, were or will be adequate to cover the total amount of all reasonably anticipated matured and unmatured Liabilities of Sheboygan Falls under all outstanding Insurance Contracts pursuant to which Sheboygan Falls has any Liability. For purposes of clause (v) above, (x) the adequacy of reserves shall be determined only on the basis of facts and circumstances known based on procedures consistently applied by Sheboygan Falls in connection with assessing the adequacy of reserves from time to time by Sheboygan Falls as at the date hereof and (y) the fact that reserves covered by any such representation may be subsequently adjusted at times and under circumstances consistent with Sheboygan Falls' ordinary practice of periodically reassessing the adequacy of its reserves shall not be used to support any claim regarding the accuracy of such representation.

(c) All of Sheboygan Falls' outstanding insurance coverage is, to the extent required by applicable Law, on forms and at rates approved by the insurance regulatory authority of the jurisdiction where issued or has been filed with and not objected to by such authority within the period provided for objection. To the Knowledge of Sheboygan Falls, Sheboygan Falls has not exceeded any authority granted to it by any party to bind it in connection with Sheboygan Falls' business.

3.14 No Undisclosed Material Liabilities. Sheboygan Falls is not subject to any material Liability, including, to Sheboygan Falls' Knowledge, unasserted claims, absolute or contingent, that is not shown or that is in excess of amounts shown or reserved for in the December 31, 2005 balance sheet referred to in Section 3.4, other than Liabilities of the same nature as those set forth in such balance sheet and reasonably incurred in the Ordinary Course of Business of Sheboygan Falls after December 31, 2005 or as otherwise disclosed in the Disclosure Schedules.

3.15 No Defaults or Litigation. Sheboygan Falls is not in default in any material respect under any Contract to which it is a party. There are no lawsuits, proceedings, claims or governmental investigations pending or, to the Knowledge of Sheboygan Falls, threatened against Sheboygan Falls or against the properties or business thereof that might, individually or in the aggregate, have a Sheboygan Falls Adverse Effect and Sheboygan Falls has no Knowledge of any factual basis for any such lawsuit, proceeding, claim or investigation and there is no action, suit, proceeding or investigation pending, threatened or contemplated that questions the legality, validity or propriety of the transactions contemplated by this Agreement.

3.16 Tax Liabilities. The amounts reflected as liabilities for Taxes on the December 31, 2005 balance sheet referred to in Section 3.4 are sufficient for the payment of all Taxes of Sheboygan Falls accrued for or applicable to the period ended on such balance sheet date and all years and periods prior thereto. All Tax Returns that are required to be filed by or in respect of Sheboygan Falls up to and including the date hereof have been filed and all Taxes, including any interest and penalties thereon, which have become due pursuant to such Returns or pursuant to any assessment have been paid and no extension of the time for filing of any such return is presently in effect. All such Returns that have been filed or will be filed by or in respect of Sheboygan Falls for any period ending on or before the Closing Date are or will be true and correct. There exists no proposed assessment against Sheboygan Falls. No consent to the application of Section 341(f)(2) of the Code has been filed with respect to any Sheboygan Falls Property. Sheboygan Falls has withheld and paid all Taxes required to have been withheld and paid in connection with amounts paid or owing to any employee, independent contractor or other third party. No claim has ever been made by a Governmental Entity in a jurisdiction where Sheboygan Falls does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. Sheboygan Falls has delivered to Donegal Mutual correct and complete copies of all federal, state and local Tax Returns, examination reports and statements of deficiencies assessed against or agreed to by Sheboygan Falls since January 1, 2001. The federal Tax Returns for Sheboygan Falls have never been examined by the IRS, and the applicable statute of limitations relating thereto has expired for the tax year ended December 31, 2002 and all prior periods.

3.17 Contracts. Sheboygan Falls is not a party to (i) any contract for the purchase or sale of real property to or from any third party; (ii) any contract for the lease or sublease of

personal property from or to any third party that provides for annual rentals in excess of \$25,000, or any group of contracts for the lease or sublease of similar kinds of personal property from or to third parties that provides in the aggregate for annual rentals in excess of \$25,000; (iii) any contract for the purchase or sale of equipment, computer software, lists of clients, insurance carriers or agents or similar information, commodities, merchandise, supplies, other materials or personal property or for the furnishing or receipt of services that calls for performance over a period of more than 60 days and involves more than the sum of \$25,000; (iv) any license agreement involving the use of copyrights, franchises, licenses, trademarks, or information owned by Sheboygan Falls or others; (v) any broker's representative, sales, agency or advertising contract that is not terminable on notice of 30 days or less; (vi) any contract involving the borrowing or lending of money or the guarantee of the obligations of officers, directors, employees or others or (vii) any other contract, whether or not made in the Ordinary Course of Business of Sheboygan Falls that is material to the business or Assets of Sheboygan Falls. No outstanding purchase commitment by Sheboygan Falls is in excess of its ordinary business requirements or at a price in excess of market price at the date thereof. None of such contracts and agreements will expire or be terminated or be subject to any modification of terms or conditions by reason of the consummation of the transactions contemplated by this Agreement. With respect to its contracts with insurance agents, none of the agents who is party to any such agreement has terminated, threatened to terminate or given any notice, written or oral, of an intention to terminate its agreement with Sheboygan Falls or to substantially reduce the volume of business placed with or through Sheboygan Falls, and Sheboygan Falls has no Knowledge of any condition or state of facts or circumstances that would cause any such termination or reduction in the foreseeable future. Sheboygan Falls is not in default in any material respect under the terms of any such contract nor is it in default in the payment of any insurance premiums due to insurance carriers nor any principal of or interest on any indebtedness for borrowed money nor has any event occurred that, with the passage of time or giving of notice, or both, would constitute such a default by Sheboygan Falls and, to the Knowledge of Sheboygan Falls, no other party to any such contract is in default in any material respect thereunder nor has any such event occurred with respect to such party. Without the prior written consent of Donegal Mutual, Sheboygan Falls will not make any changes or modifications in any of the foregoing, nor incur any further obligations or commitments, nor make any further additions to its properties, except in each case in the Ordinary Course of Business of Sheboygan Falls and as contemplated by this Agreement.

3.18 Employee Agreements. Listed on Schedule 3.18 are all plans, contracts and arrangements, oral or written, including but not limited to, union contracts, employee benefit plans, deferred compensation agreements, split dollar agreements, employment agreements, consulting agreements, confidentiality agreements, non-competition agreements or other agreements with any of Sheboygan Falls' employees, whereunder Sheboygan Falls has any obligation, other than obligations to make current wage or salary payments terminable on

notice of 30 days or less, to or on behalf of its officers, employees or their beneficiaries or whereunder any of such persons owes money to Sheboygan Falls.

3.19 Employee Relations. Sheboygan Falls has not engaged in any unfair labor practice, unlawful employment practice or unlawful discriminatory practice in the conduct of its business. To the Knowledge of Sheboygan Falls, Sheboygan Falls has complied in all material respects with all applicable Laws relating to wages, hours and collective bargaining and has withheld all amounts required by agreement to be withheld from the wages or salaries of employees. Sheboygan Falls is not a party to or affected by or threatened with, or to the Knowledge of Sheboygan Falls in danger of, being a party to or affected by, any labor dispute that materially interferes or would materially interfere with the conduct of its business. There is set forth in Schedule 3.19 the name and total annual compensation, including bonuses, payable to each of the officers, directors and employees of Sheboygan Falls whose total annual compensation, including bonuses, during the year ended December 31, 2005 exceeded the sum of \$75,000. Since December 31, 2005, there has been no material increase in the compensation payable to any of such officers, directors or employees, except as set forth in Schedule 3.19.

3.20 Employee Retirement Income Security Act.

(a) Schedule 3.18 contains a list of any "employee benefit plan" within the meaning of Section 3(3) of ERISA established or maintained by Sheboygan Falls or to which Sheboygan Falls has made any contribution. Sheboygan Falls is not required, and was not required within the immediately preceding five years, to make any contribution to any "multiemployer plan" within the meaning of Section 3(37) of ERISA. Sheboygan Falls has no liability in respect of any employee benefit plan established or maintained or to which contributions are or were made by it to the PBGC or to any beneficiary of such plans. All required reports and descriptions, including Form 5500 Annual Reports, summary annual reports, PBGC-1's and summary plan descriptions, have been timely filed and distributed appropriately with respect to each such employee benefit plan. The requirements of COBRA have been met with respect to each such employee benefit plan that is an Employee Welfare Plan.

(b) (i) No employee pension benefit plan, as defined in Section 3(2) of ERISA, maintained or contributed to by Sheboygan Falls or in respect of which Sheboygan Falls is considered an "employer" under Section 414 of the Code, has incurred any "accumulated funding deficiency," as defined in Section 412 of the Code, whether or not waived, or has incurred any liability to PBGC and (ii) to the Knowledge of Sheboygan Falls, Sheboygan Falls has not breached any of the responsibilities, obligations or duties imposed on it by ERISA with respect to any employee pension benefit plan maintained by it, which breach has given rise to, or will in the future give rise to, an obligation to pay money. To the Knowledge of Sheboygan Falls, neither Sheboygan Falls nor any of its affiliates or, to the Knowledge of Sheboygan Falls, any "party in interest," as defined in Section 3(14) of ERISA,

in respect of any such plan has engaged in any non-exempted prohibited transaction described in Sections 406 and 408 of ERISA or Section 4975 of the Code. No reportable event, as defined in Section 4043 of ERISA, has occurred with respect to any employee pension benefit plan maintained or contributed to by Sheboygan Falls or in respect of which Sheboygan Falls is an employer under Section 414 of the Code and none of such plans has been terminated by the plan administrator thereof or by the PBGC. To the Knowledge of Sheboygan Falls, none of Sheboygan Falls or its affiliates has incurred any liability for non-compliance with ERISA or any regulations thereunder. The original or a complete and correct copy of each plan listed in Schedule 3.18 has been delivered to Donegal Mutual.

3.21 Conflicts; Sensitive Payments. To the Knowledge of Sheboygan Falls, there are (i) since January 1, 2001, no material situations involving the interests of Sheboygan Falls or, to the Knowledge of Sheboygan Falls, any officer or director of Sheboygan Falls, that may be generally characterized as a “conflict of interest,” including, but not limited to, the leasing of property to or from Sheboygan Falls or direct or indirect interests in the business of competitors, suppliers or customers of Sheboygan Falls and (ii) no situations involving illegal payments or payments of doubtful legality from corporate funds of Sheboygan Falls since January 1, 2001 to governmental officials or others that may be generally characterized as a “sensitive payment.”

3.22 Corporate Name. Sheboygan Falls owns and possesses all rights to the use of the name Sheboygan Falls Mutual Insurance Company in the operation of Sheboygan Falls’ present business or any other business similar to or competitive with that being conducted by Sheboygan Falls, including, but not limited to, the right to use such name in advertising.

3.23 Trademarks and Proprietary Rights. Sheboygan Falls is legally entitled to use all trademarks, trade names, copyrights, processes and other technical know-how and other proprietary rights now used in the conduct of its business and has not received any notice of conflict with the asserted rights of others.

3.24 Environmental Matters.

(a) Sheboygan Falls is, and, to the Knowledge of Sheboygan Falls, all Sheboygan Falls Properties including, with respect to any Sheboygan Falls Property, all owners or operators thereof, are, and at all times have been in substantial compliance with all applicable Environmental Laws. Sheboygan Falls has not received any communication, written or oral, that alleges that Sheboygan Falls or any Sheboygan Falls Property including, with respect to any Sheboygan Falls Property, any owner or operator thereof, is not in such compliance, and, to the Knowledge of Sheboygan Falls, there are no circumstances that may prevent or interfere with such compliance in the future.

(b) There is no Environmental Claim pending against Sheboygan Falls or any Sheboygan Falls Property or, to the Knowledge of Sheboygan Falls, threatened against Sheboygan Falls or any Sheboygan Falls Property, or any Person whose Liability for any Environmental Claims Sheboygan Falls has or may have retained or assumed either contractually or by operation of Law, except for Environmental Claims that, individually or in the aggregate, would not have a Sheboygan Falls Adverse Effect.

(c) There are no past or present actions, activities, circumstances, conditions, events or incidents, including, without limitation, the release, emission, discharge, disposal or presence of any Hazardous Materials, that, to the Knowledge of Sheboygan Falls, could form the basis of any Environmental Claim against Sheboygan Falls, any Sheboygan Falls Property or any Person whose Liability for any Environmental Claim Sheboygan Falls has or may have retained or assumed either contractually or by operation of Law.

(d) There are no Hazardous Materials present on or in any Sheboygan Falls Property, including Hazardous Materials contained in barrels, above or underground storage tanks, landfills, land deposits, dumps, equipment, whether movable or fixed, or other containers, either temporary or permanent, and deposited or located in land, water, sumps or any other part of Sheboygan Falls Property or such adjoining property, or incorporated into any structure therein or thereon.

(e) Without in any way limiting the generality of the foregoing, to the Knowledge of Sheboygan Falls, (i) there are no underground storage tanks and currently or formerly located on any Sheboygan Falls Property, (ii) there is no friable asbestos contained in or forming part of any building or structure owned or leased by Sheboygan Falls and (iii) no polychlorinated biphenyls are used or stored at or on any Sheboygan Falls Property.

3.25 Insurance Issued by Sheboygan Falls.

(a) Sheboygan Falls has provided a list of all forms of Insurance Contracts used by Sheboygan Falls as of November 1, 2006 to Donegal Mutual, and has made available to Donegal Mutual copies of all forms of Insurance Contracts used by Sheboygan Falls as of November 1, 2006 that are not standard Insurance Services Office forms. Since November 1, 2006, no forms of Insurance Contracts written by Sheboygan Falls have been amended and no sales of any new forms of Insurance Contracts have been commenced, other than changes to forms, which changes are not, in the aggregate, material.

(b) To the Knowledge of Sheboygan Falls, all benefits payable on or prior to the date as of which this representation is made by Sheboygan Falls under Insurance Contracts have in all material respects been paid, or provision for payment thereof has been made, in accordance with the terms of the Insurance Contracts under which they arose, such payments were not delinquent and were paid, or if provision has been made will be paid, without fines or penalties, except for fines or penalties that do not exceed \$10,000,

individually, or \$25,000, in the aggregate, and except for such benefits for which Sheboygan Falls reasonably believes there is a reasonable basis to contest payment and is taking such action.

(c) To the Knowledge of Sheboygan Falls, all outstanding Insurance Contracts of Sheboygan Falls were issued in conformity with underwriting standards that conform in all material respects to industry accepted practices and, with respect to Insurance Contracts reinsured in whole or in part, conform in all material respects to the standards required pursuant to the terms of the related reinsurance, coinsurance or other similar Contracts.

(d) To the Knowledge of Sheboygan Falls, (i) all amounts recoverable under reinsurance, coinsurance or other similar Contracts including, without limitation, amounts based on paid and unpaid Losses are fully collectible; (ii) each insurance agent or broker, at the time such agent or broker wrote, sold or produced business for Sheboygan Falls, was duly licensed as an insurance agent or broker for the type of business written, sold or produced by such insurance agent or broker in the particular jurisdiction in which such agent or broker wrote, sold or produced such business for Sheboygan Falls, except for such failures to be so licensed that would not, in the aggregate, have a Sheboygan Falls Adverse Effect and (iii) no such insurance agent or broker has violated or has taken any action that with notice or lapse of time or both, would have violated any Law except for such violations as would not have a Sheboygan Falls Adverse Effect.

(e) Sheboygan Falls has no outstanding Liability under assumed reinsurance agreements of any nature.

3.26 Health and Safety Matters.

(a) To the Knowledge of Sheboygan Falls, Sheboygan Falls has complied and is in compliance with all Health and Safety Requirements.

(b) Without limiting the generality of the foregoing, Sheboygan Falls has obtained and complied with, and is in compliance with, all Permits, licenses and other authorizations that are required pursuant to the Health and Safety Requirements for the occupation of its facilities and the operation of its business.

(c) Sheboygan Falls has not received any written or oral notice, report or other information regarding any actual or alleged violation of Health and Safety Requirements, or any Liabilities or potential Liabilities, including any investigatory, remedial or corrective obligations, relating to Sheboygan Falls or its facilities arising under Health and Safety Requirements.

3.27 No Omissions. None of the representations or warranties of Sheboygan Falls contained herein, none of the information contained in the Schedules referred to in this

Article III and none of the other information or documents furnished to Donegal Mutual or its representatives by Sheboygan Falls in connection with this Agreement is false or misleading in any material respect or omits to state a fact herein or therein necessary to make the statements herein or therein not misleading in any material respect. To the Knowledge of Sheboygan Falls, there is no fact that adversely affects, or in the future is reasonably likely to affect adversely, the business or Assets of Sheboygan Falls in any material respect that has not been disclosed in writing to Donegal Mutual.

3.28 Finders. Sheboygan Falls has not paid or become obligated to pay any fee or commission to any broker, finder or intermediary. Notwithstanding the foregoing, Sheboygan Falls shall be responsible for the payment of all fees and expenses payable for or on account of the transactions provided for in this Agreement based on actions taken or agreements entered into by Sheboygan Falls. Sheboygan Falls does not have any agreement or obligation whatsoever with entities other than Donegal Mutual regarding any proposed affiliation or acquisition of Sheboygan Falls by any such entity and is not engaged in any negotiations with any such entity for any such affiliation or acquisition.

3.29 Representations and Warranties to Be True on the Closing Date. All of the representations and warranties set forth in this Article III shall be true and correct on the Closing Date.

ARTICLE IV

REPRESENTATIONS AND WARRANTIES OF DONEGAL MUTUAL

Donegal Mutual represents and warrants to Sheboygan Falls as follows:

4.1 Organization and Standing.

(a) Donegal Mutual is a fire casualty insurance company duly organized, validly existing and in good standing under the Laws of the Commonwealth of Pennsylvania and has the requisite corporate power and authority to conduct its business as it is currently being conducted. Donegal Mutual is duly qualified to do business and is in good standing in the respective jurisdictions where the character of its Assets owned or leased or the nature of its business makes such qualification necessary.

(b) Copies of the Articles of Incorporation and By-laws of Donegal Mutual have heretofore been delivered or made available to Sheboygan Falls, and all such copies are accurate and complete as of the date hereof.

4.2 Authorization. Donegal Mutual has the requisite corporate power and authority to execute and deliver this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement and to consummate the

transactions contemplated hereby and thereby. The execution and delivery of this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement and the consummation of the transactions contemplated hereby and thereby have been duly approved and authorized by the Board of Directors of Donegal Mutual. No other corporate proceedings on the part of Donegal Mutual are necessary to authorize this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement and the transactions contemplated hereby and thereby. This Agreement and the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement when executed and delivered by Donegal Mutual and assuming the due execution thereof by the other parties thereto, will constitute the valid, legal and binding obligations of Donegal Mutual enforceable against Donegal Mutual in accordance with their respective terms, except that (i) such enforcement may be subject to bankruptcy, rehabilitation, liquidation, conservation, dissolution, insolvency, reorganization, moratorium or other similar Laws now or hereafter in effect relating to creditors' rights generally and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any Proceeding therefor may be brought.

4.3 Consents and Approvals of Government Agencies. Other than Required Filings and Approvals, no consent, approval, Order or authorization of, or registration, application, declaration or filing with any Person is required with respect to Donegal Mutual in connection with the execution and delivery of this Agreement, the Services Agreement, the Technology License Agreement and the Retrocessional Reinsurance Agreement and the consummation of the transactions contemplated hereby, nor compliance with nor fulfillment of the terms and provisions hereof and thereof, will (i) conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under the Amended Articles of Incorporation or the Amended and Restated By-laws of Donegal Mutual, or any instrument, agreement, mortgage, judgment, Order, award, decree or other restriction to which Donegal Mutual is party; (ii) give any party to or with rights under any such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction or (iii) require the approval, consent or authorization of or any filing with or notification to any federal, state or local court, Governmental Entity, except (y) the Required Filings and Approvals and (z) any approval, consent or authorization the failure of which to obtain would not, individually or in the aggregate, have a Donegal Mutual Adverse Effect.

4.4 Transferability. The Note will be acquired by Donegal Mutual for its own account and not with a view to, and not in connection with, a public distribution or resale thereof and will not be transferred except in a transaction registered or exempt from registration under the Securities Act. It is understood that Donegal Mutual's investments are at all times within its control and direction.

4.5 No Omissions. None of the representations or warranties of Donegal Mutual contained herein, and none of the other information or documents furnished to Sheboygan Falls or its representatives by Donegal Mutual in connection with this Agreement is false or misleading in any material respect or omits to state a fact herein or therein necessary to make the statements herein or therein not misleading in any material respect. To the Knowledge of Donegal Mutual, there is no fact that adversely affects, or in the future is reasonably likely to affect adversely, the business or Assets of Donegal Mutual that has not been disclosed in writing to Sheboygan Falls.

4.6 Finders. Donegal Mutual has not paid or become obligated to pay any fee or commission to any broker, finder or intermediary on account of the transactions provided for in this Agreement, except for Sanders. Donegal Mutual shall be responsible for the payment of all fees and expenses payable for or on account of the transactions provided for in this Agreement and other such fees based on actions taken or agreements entered into by Donegal Mutual.

4.7 Representations and Warranties to Be True on the Closing Date. All of the representations and warranties set forth in this Article IV shall be true and correct on the Closing Date.

ARTICLE V
CERTAIN COVENANTS

The parties covenant and agree to take the following action between the date hereof and the Closing Date:

5.1 Investigation of Sheboygan Falls and Donegal Mutual.

(a) Sheboygan Falls shall afford to the officers, employees and authorized representatives, including, without limitation, independent public accountants and attorneys, of Donegal Mutual such reasonable access upon reasonable prior notice during normal working hours to the offices, properties, personnel, business and financial and other records of Sheboygan Falls as Donegal Mutual shall deem necessary or desirable, and shall furnish to Donegal Mutual or its authorized representatives such additional documents and financial and operating and other data as Donegal Mutual shall reasonably require, including all such documents, information and data as shall be necessary in order to enable Donegal Mutual or its representatives to verify to their satisfaction the accuracy of the Sheboygan Falls Financial Statements and the representations and warranties contained in Article III of this Agreement. No investigation made by Donegal Mutual or its representatives shall affect the representations and warranties of Sheboygan Falls hereunder or the liability of Sheboygan Falls with respect thereto.

(b) Donegal Mutual shall afford to the officers, employees and authorized representatives, including, without limitation, independent public accountants and attorneys, of Sheboygan Falls such reasonable access upon reasonable prior notice during normal working hours to the offices, properties, personnel, business and financial and other records of Donegal Mutual as Sheboygan Falls shall deem necessary or desirable, and shall furnish to Sheboygan Falls or its authorized representatives such additional documents and financial and operating and other data as Sheboygan Falls shall reasonably require, including all such documents, information and data as shall be necessary in order to enable Sheboygan Falls or its representatives to verify to their satisfaction the accuracy of the representations and warranties contained in Article IV of this Agreement. No investigation made by Sheboygan Falls or its representatives shall affect the representations and warranties of Donegal Mutual hereunder or the liability of Donegal Mutual with respect thereto.

5.2 Confidential Nature of Information. Donegal Mutual and Sheboygan Falls agree that, in the event that the transactions contemplated herein shall not be consummated, each will treat in confidence all documents, materials and other information that it shall have obtained during the course of the negotiations leading to this Agreement, the investigation of the other party hereto and the preparation of this Agreement and other documents relating to this Agreement with the exception of any filings made by Donegal Mutual or Sheboygan Falls with the OCI (collectively, the "Confidential Information"), and shall return to the other party all copies of the Confidential Information that have been furnished in connection therewith. In the event that a party hereto becomes legally compelled to disclose any of the Confidential Information, it shall provide the other party with reasonable notice so that it may seek a protective order or other appropriate remedy or waive compliance with the provisions of this Section 5.2. In the event that such protective order or other remedy is not obtained or that the other party waives compliance with the provisions of this Section 5.2, the first party will furnish only that portion of the Confidential Information that it is advised by opinion of counsel, which counsel shall be reasonably acceptable to the other party, is legally required and will endeavor to obtain assurance that confidential treatment will be accorded the Confidential Information so furnished. Donegal Mutual and Sheboygan Falls agree and acknowledge that a breach of the provisions of this Section 5.2 may cause the other party to suffer irreparable damage that could not be adequately remedied by an action at law. Accordingly, each party agrees that the other party shall have the right to seek specific performance of the provisions of this Section 5.2 to enjoin a breach or attempted breach of the provisions of this Section 5.2, such right being in addition to all other rights and remedies that are available to each party at law, in equity or otherwise. The foregoing shall be in addition to the rights and obligations under the Existing Confidentiality Agreements.

5.3 Preserve Accuracy of Representations and Warranties.

(a) Sheboygan Falls shall refrain from taking any action that would render any representation or warranty contained in Article III of this Agreement inaccurate as of the

Closing Date. Sheboygan Falls will promptly notify Donegal Mutual of any lawsuits, claims, proceedings or investigations that, to the Knowledge of Sheboygan Falls, may be threatened, brought, asserted or commenced against Sheboygan Falls, its officers or its directors (i) involving in any way the transactions contemplated by this Agreement or (ii) that would, if determined adversely, have a Sheboygan Falls Adverse Effect.

(b) Donegal Mutual shall refrain from taking any action that would render any representation or warranty contained in Article IV of this Agreement inaccurate as of the Closing Date. Donegal Mutual will promptly notify Sheboygan Falls of any lawsuits, claims, proceedings or investigations that, to the Knowledge of Donegal Mutual, may be threatened, brought, asserted or commenced against Donegal Mutual, its officers or its directors (i) involving in any way the transactions contemplated by this Agreement or (ii) that would, if determined adversely, have a Donegal Mutual Adverse Effect.

5.4 Maintain Sheboygan Falls As a Going Concern. Except as otherwise specifically provided herein, Sheboygan Falls shall conduct its business in accordance with past practices and use its best efforts to maintain its business organization intact, keep available the services of Sheboygan Falls' officers, employees and agents and preserve the good will of its insurance underwriters, employees, clients and others having business relations with it. Sheboygan Falls shall provide Donegal Mutual promptly with interim monthly financial information and any other management reports, as and when they shall become available, confer with Donegal Mutual concerning operational matters of a material nature and otherwise report periodically to Donegal Mutual concerning the status of the business, operations and financial condition of Sheboygan Falls.

5.5 Make No Material Change in Sheboygan Falls. Prior to the Closing Date, Sheboygan Falls shall not, without the prior written approval of Donegal Mutual, (i) make any material change in the business or operations of Sheboygan Falls except as set forth in this Agreement; (ii) make any material change in the accounting policies applied in the preparation of the financial statements referred to in Section 3.4; (iii) make any material change in the compensation of officers, directors or key employees of Sheboygan Falls other than in the Ordinary Course of Business of Sheboygan Falls; (iv) enter into any contract, license, franchise or commitment other than in the Ordinary Course of Business of Sheboygan Falls or waive any rights of substantial value; (v) make any donation to any charitable, civic, educational or other eleemosynary institution in excess of donations made in comparable past periods, (vi) make any reduction in any loss expense reserve or incurred but not reported reserve prior to the Closing Date; (vii) make any change in the levels, procedures or methods employed in the setting or changing of case basis loss reserves; (viii) make any reduction in net case basis loss reserves not consistent with the levels, procedures or methods employed by Sheboygan Falls in the setting or changing of case basis loss reserves as in effect on the date hereof and, in any event, within 10 days following any reduction in Sheboygan Falls' net case basis loss reserve in any one claim file in excess of

\$25,000, except for a reduction occurring because a payment has been made on the reserve or because the claim has been settled and the case closed, and, in any case, Sheboygan Falls shall provide Donegal Mutual with a written explanation of such reduction in reasonable detail certified by Sheboygan Falls' President or (ix) enter into any other transaction affecting in any material respect the business of Sheboygan Falls other than in the Ordinary Course of Business of Sheboygan Falls and in conformity with the past practices of Sheboygan Falls or as contemplated by this Agreement.

5.6 No Public Announcement. Neither Sheboygan Falls nor Donegal Mutual shall, without the approval of the other, make any press release or other public announcement or filing concerning the transactions contemplated by this Agreement, except as and to the extent that any such party shall so determine is required by law, in which case the other party shall be advised thereof and given a reasonable opportunity to comment thereon.

5.7 Required Filings. As promptly as practical after the date of this Agreement, Sheboygan Falls and Donegal Mutual shall promptly commence and make all Required Filings with the appropriate Governmental Entity required by Law to be made by any of them in order to consummate the transactions contemplated by this Agreement. Between the date of this Agreement and the Closing Date, Sheboygan Falls shall cooperate with Donegal Mutual with respect to all Required Filings that Donegal Mutual elects to make or is required by law to make in connection with the transactions contemplated by this Agreement.

5.8 No Solicitation. Sheboygan Falls shall not, nor shall it authorize or permit any of its officers, directors or employees or any investment banker, financial advisor, attorney, accountant, actuary or other Person retained by it or on its behalf to: (a) solicit or encourage, including, without limitation, by way of furnishing information, or take any action to facilitate or pursue, any inquiries or the making of any proposal that constitutes, or may reasonably be expected to lead to, any Reorganization Proposal or (b) agree to, approve or endorse any Reorganization Proposal; provided, however, that nothing contained in this Section 5.8 shall prohibit the Board of Directors of Sheboygan Falls from furnishing information to, or entering into discussions or negotiations with, any person or entity that made an unsolicited bona fide proposal to acquire Sheboygan Falls pursuant to a Reorganization Proposal if and only to the extent that, (A) the Board of Directors of Sheboygan Falls determines in good faith that such action is required to comply with its fiduciary duties to its members imposed by Law, (B) prior to furnishing such information to, or entering into discussions or negotiations with, such person or entity, Sheboygan Falls provides written notice to Donegal Mutual to the effect that it is furnishing information to, or entering into discussions or negotiations with, such person or entity and (C) Sheboygan Falls continues to keep Donegal Mutual informed of the status of any such discussions or negotiations. Nothing in this Section 5.8 shall (x) permit Sheboygan Falls to terminate this Agreement, except as specifically provided in Article VII, (y) permit Sheboygan Falls to enter into any agreement with respect to a Reorganization Proposal during the term of this

Agreement or (z) affect any other obligation of Sheboygan Falls under this Agreement. Sheboygan Falls shall promptly advise Donegal Mutual orally and in writing of any such inquiries or proposals however preliminary and whether written or oral, and shall communicate the full and complete details of any such inquiry or proposal including, without limitation, the identity of all Persons involved. As used in this Agreement, "Reorganization Proposal" shall mean any proposal for, or to discuss, a merger, consolidation, sale of all or substantially all of the Assets, demutualization, bulk or assumption reinsurance arrangement or other reorganization, arrangement or business combination involving Sheboygan Falls or any proposal or offer for, or to discuss, the acquisition in any manner of control of a substantial portion of the Assets of or business conducted by Sheboygan Falls other than the transactions contemplated by this Agreement.

5.9 Future Actions Regarding Sheboygan Falls. Donegal Mutual and Sheboygan Falls agree that the following undertakings with respect to certain future action relating to Sheboygan Falls were important inducements to the decision of Sheboygan Falls and Donegal Mutual to enter into this Agreement.

(a) Donegal Mutual and Sheboygan Falls have agreed that until the later to occur of (i) repayment of the principal amount and all accrued but unpaid interest on the Note and (ii) the termination of the Technology License Agreement in accordance with its terms, Sheboygan Falls shall use its best efforts to assure that the Board of Directors of Sheboygan Falls shall consist of ten members, four of whom shall be designees of Sheboygan Falls and six of whom shall be designees of Donegal Mutual. In furtherance of this undertaking, Donegal Mutual agrees, for a period of not less than five years from the Closing Date, to cause its designees on the Sheboygan Falls' Board of Directors to nominate for election as successors to the initial Sheboygan Falls' designees persons who are residents of the Greater Sheboygan Falls, Wisconsin metropolitan area. Following the later to occur of (i) five years from the Closing Date or (ii) the date on which Sheboygan Falls shall have become a wholly owned subsidiary of Donegal Mutual or Donegal Group Inc. ("DGI"), Donegal Mutual agrees, and agrees to cause DGI to agree, to maintain an appropriate Wisconsin presence on the Board of Directors of the converted Sheboygan Falls.

(b) For a period of five years from the Closing Date, Donegal Mutual will not take any action to relocate or close the existing facilities of Sheboygan Falls in Sheboygan Falls, Wisconsin. For a period commencing on the fifth anniversary of the Closing Date and ending on the tenth anniversary of the Closing Date, Donegal Mutual agrees not to take any action to relocate or close the existing facilities of Sheboygan Falls in Sheboygan Falls, Wisconsin unless such relocation or closure is approved by the affirmative vote of eight members of the Board of Directors of Sheboygan Falls.

(c) Donegal Mutual agrees to use commercially reasonable efforts to maintain continued employment of underwriting, claims and marketing personnel at

Sheboygan Fall's home office, with the levels of employment commensurate with the Wisconsin premium volume of Sheboygan Falls and Donegal Mutual.

(d) Donegal Mutual agrees not to cause the termination of the existing executive bonus plan unless a management bonus plan is adopted in its place that provides for potential bonuses that are equal to or greater than the potential bonuses under the existing Sheboygan Falls executive bonus plan.

(e) Unless and until the demutualization of Sheboygan Falls occurs, Donegal Mutual agrees to take no action to cause the termination of any of the existing employee benefit plans maintained by Sheboygan Falls. Notwithstanding the foregoing, Donegal Mutual and Sheboygan Falls agree to evaluate the termination or freezing of Sheboygan Fall's defined benefit pension plan pursuant to which all employees of Sheboygan Falls would become fully vested in all funded benefits under Sheboygan Fall's defined benefit pension plan and the adoption, in lieu thereof, of a 401(k) plan to which Sheboygan Falls would make contributions on behalf of its employees. To the extent Sheboygan Falls shall terminate any other Sheboygan Falls employee benefit plan, Sheboygan Falls shall adopt a successor plan under which the employees of Sheboygan Falls shall be entitled to substantially comparable benefits under such new plans.

(f) For as long as the Services Agreement remains in effect, Donegal Mutual agrees that:

(i) Sheboygan Falls will be a major writing company in Wisconsin for the Donegal Insurance Group;

(ii) Donegal Mutual will assist Sheboygan Falls in offering an expanded line of personal and commercial coverages;

(iii) Donegal Mutual will assist Sheboygan Falls in soliciting agency appointments; and

(iv) The current book of business written by Sheboygan Falls will be retained by Sheboygan Falls and will not be transferred to Donegal Mutual, except as contemplated by the Retrocessional Reinsurance Agreement.

(g) Donegal Mutual agrees to work with Sheboygan Falls to identify the most cost-effective reinsurance for Sheboygan Falls; provided, however, that this provision shall not obligate Donegal Mutual to accept any reinsurance from Sheboygan Falls other than pursuant to the Retrocessional Reinsurance Agreement.

(h) Donegal Mutual and Sheboygan Falls agree to establish, within 30 days from the date of the Closing, a technology transition team consisting of employees of Donegal Mutual and employees of Sheboygan Falls to facilitate the commencement of a

transition, within six months from the date of the Closing, from Sheboygan Fall's current computer systems to Donegal Mutual's computer systems. Upon completion of such transition, and subject to the terms of the Technology License Agreement, Donegal Mutual will make its technology, including its WritePro automated personal lines underwriting and policy issuance system, available to Sheboygan Falls. In connection therewith, Donegal Mutual and Sheboygan Falls agree as follows:

(i) Sheboygan Falls shall reimburse Donegal Mutual for the direct costs, including salary and benefits, of Donegal Mutual's employees performing systems analysis, programming and product development services in the process of converting Sheboygan Falls' information systems to Donegal Mutual's information systems. Employees of Donegal Mutual performing such services will maintain a record of time spent working on the system conversion project, and costs will be charged to Sheboygan Falls on a monthly basis based upon the employees' actual hourly rate and a factor representing Donegal Mutual's average benefits cost as a percentage of salaries expense with no additional overhead charge to Sheboygan Falls. Donegal Mutual agrees that the costs of its services in assisting in the conversion of Sheboygan Falls' information systems to Donegal Mutual's information systems will not exceed \$100,000. Such costs exclude any licensing fees or other direct charges from third party vendors Donegal Mutual will be required to pay under license agreements relating to Donegal Mutual's information systems in order to include Sheboygan Falls under such license agreements and Sheboygan Falls shall reimburse Donegal Mutual for all such license fees or other direct charges from third party vendors in addition to the costs of Donegal Mutual's services as provided in the immediately preceding sentence.

(ii) Upon the conversion of Sheboygan Falls' information systems to Donegal Mutual's information systems, calculation and settlement of allocations and reimbursements for information services provided by Donegal Mutual on behalf of Sheboygan Falls shall be performed as follows:

(A) Sheboygan Falls shall be included in the calculations currently performed to determine the allocation of Donegal Mutual's information systems costs among the companies that currently receive information services from Donegal Mutual. Donegal Mutual's estimated purchase price and development costs of computer hardware and software systems required to provide such services are divided by the number of years those systems are reasonably expected to serve the respective information services requirements of Donegal Mutual and its affiliates. Such estimated annual cost is then allocated to the respective companies based upon their proportionate net written premiums in the year prior to the establishment of the allocation amounts. Donegal Mutual agrees that the percentage allocation to Sheboygan Falls shall not exceed 1.0% of Sheboygan Falls' net premiums written for a period of two years following the first allocation billing.

(B) Sheboygan Falls shall reimburse Donegal Mutual for the amounts so allocated on a monthly basis. Monthly allocations will be charged beginning in the month following the date of the first issuance of a Sheboygan Falls policy on Donegal Mutual's information systems.

5.10 Affirmative Covenants of Sheboygan Falls. Beginning with the date, if any, while the Note shall be outstanding on which the designees of Donegal Mutual cease to constitute a majority of the members of the Board of Directors of Sheboygan Falls, Sheboygan Falls shall:

(a) Furnish to Donegal Mutual:

(i) within 45 days after the close of each of the first three quarters of each of Sheboygan Falls' fiscal years, a balance sheet of Sheboygan Falls as of the end of such quarter and a statement of operations for the period commencing at the end of the previous fiscal year and ending with the end of such quarter, each certified by the Chief Financial Officer of Sheboygan Falls;

(ii) within 60 days after the close of each fiscal year of Sheboygan Falls commencing in 2008, a balance sheet of Sheboygan Falls as of the end of such fiscal year and a statement of operations of Sheboygan Falls for such fiscal year accompanied by the unqualified opinion with respect thereto of KPMG LLP or other independent public accountants of recognized national standing;

(iii) promptly upon their becoming available, all regular and periodic financial and other reports that Sheboygan Falls shall file with any regulatory authority having jurisdiction over it or its operations;

(iv) immediately upon receipt, a copy of all written communications and a written summary of all material oral communications specifically addressed to Sheboygan Falls, and not to Wisconsin-domiciled insurers in general, shall receive from any regulatory agency having jurisdiction over it or its operations;

(v) such other information respecting the financial condition and operations of Sheboygan Falls as Donegal Mutual may from time to time reasonably request; and

(vi) immediate notice of the institution of any litigation, administrative proceeding or governmental investigation, other than routine litigation ordinarily incident to Sheboygan Falls' insurance business or the entry of any judgment, decree or Order against or involving Sheboygan Falls that might result in a Sheboygan Falls Adverse Effect or affect the enforceability of the Note or Sheboygan Falls' ability to obtain approval of the Commissioner of Insurance to make payments of principal of, or accrued interest on, the Note;

(b) Preserve and keep in full force and effect its existence as a mutual fire and casualty insurance company under the Laws of the State of Wisconsin and its admission to transact an insurance business in Wisconsin; and

(c) At any reasonable time and from time to time, permit Donegal Mutual or any agents or representatives thereof to examine and make copies of and take abstracts from the records and books of account of, and visit the properties of, Sheboygan Falls during regular business hours and upon five days prior notice to Sheboygan Falls, and to discuss the affairs, finances and accounts of Sheboygan Falls with Sheboygan Falls' officers.

5.11 Negative Covenants of Sheboygan Falls. Beginning with the date, if any, while the Note shall be outstanding on which the designees of Donegal Mutual cease to constitute a majority of the members of the Board, Sheboygan Falls shall not, without the prior written consent of Donegal Mutual:

(a) Create, incur, assume, guarantee, suffer to exist or in any other manner become liable for any indebtedness except for (i) the indebtedness evidenced by the Note, (ii) indebtedness existing on such date and reflected in Sheboygan Falls' financial statements for the quarter ended immediately preceding this Section 5.11 becoming effective and (iii) indebtedness for borrowed money or for the deferred purchase price of property incurred in connection with the acquisition of real or personal property not to exceed \$250,000 in aggregate principal amount at any time outstanding and any extension, refunding or renewal of any such indebtedness referred to in this clause (iii) not resulting in an increase in the principal amount thereof;

(b) Merge or consolidate with or into, reinsure, or sell, assign, lease or otherwise dispose of, whether in one transaction or in a series of transactions, all or substantially all of its Assets, whether now owned or hereafter acquired, to any Person, except in the ordinary course of business and for consideration that is at least equal to the fair value of the Assets being sold or otherwise disposed of as determined by the Board of Directors of Sheboygan Falls acting in good faith;

(c) Return any capital to its members as such or make any distribution of its Assets to its members as such, except workers' compensation dividends paid in the Ordinary Course of Business;

(d) Prepay any indebtedness to any Person unless after giving effect to such prepayment Sheboygan Falls has surplus, exclusive of the then outstanding principal balance of the Note, in an amount not less than 300% of the then outstanding principal balance of the Note;

(e) Enter into or permit any Reorganization Proposal; or

(f) Voluntarily dissolve, liquidate or wind up Sheboygan Falls' affairs or file for bankruptcy or reorganization or any similar proceedings.

ARTICLE VI
CONDITIONS

6.1 Conditions to Each Party's Obligations. The respective obligations of each party to effect the purchase and sale of the Note and their other respective obligations under this Agreement shall be subject to the fulfillment at or prior to the Closing Date of the following conditions:

(a) All Required Filings and Approvals required to be obtained prior to the Closing Date solely for this Agreement, the Ancillary Documents and the Amended and Restated Bylaws and the election of designees of Donegal Mutual as a majority of the members of the Board of Directors of Sheboygan Falls shall have been obtained and not rescinded or adversely modified or limited as set forth in the proviso below or, if merely required to be filed, such filings shall have been made and accepted, and all waiting periods prescribed by applicable Law shall have expired or been terminated in accordance with applicable Law; provided that such approvals shall not contain any conditions or limitations that compel or seek to compel Sheboygan Falls to dispose of all or any portion of the business or Assets of Sheboygan Falls or impose or seek to impose any limitation on the ability of Sheboygan Falls to conduct its business or own its Assets after the Closing Date in substantially the same manner as Sheboygan Falls may presently conduct its business or own its Assets;

(b) No Order entered or Law promulgated or enacted by any Governmental Entity shall be in effect that would prevent the consummation of the purchase or sale of the Note or the other transactions contemplated hereby and no Proceeding brought by a Governmental Entity shall have been commenced and be pending that seeks to restrain, prevent or materially delay or restructure the transactions contemplated hereby or that otherwise questions the validity or legality of any such transaction; and

(c) There shall be no pending or threatened litigation initiated by a private party seeking to restrain, prevent, rescind or change the terms of this Agreement or the sale of the Note or to obtain damages in connection with this Agreement or the consummation thereof or with the sale of the Note that, in the reasonable opinion of Sheboygan Falls, makes it inadvisable to proceed with this Agreement or with the sale of the Note.

6.2 Conditions to Obligations of Donegal Mutual. The obligations of Donegal Mutual to purchase and pay for the Note and to perform its other obligations hereunder to be

performed on the Closing Date shall, at the option of Donegal Mutual, be subject to the satisfaction, on or prior to the Closing Date, of the following conditions:

(a) Sheboygan Falls shall have performed or complied in all material respects with all agreements required to be performed and complied with by it under this Agreement, including the deliveries required by Section 2.3(b), at or prior to the Closing Date and Donegal Mutual shall have received an Officer's Certificate to that effect, dated as of the Closing Date, and signed on behalf of Sheboygan Falls.

(b) Each of the representations and warranties of Sheboygan Falls contained in this Agreement that is qualified by materiality shall be true and correct on the Closing Date as though made on the Closing Date and each of the representations and warranties of Sheboygan Falls that is not so qualified shall be true and correct in all material respects on the Closing Date as though made on the Closing Date, other than representations and warranties that address matters only as of a certain date, which shall be true and correct in all material respects as of such certain date, and there shall have been delivered to Donegal Mutual an Officer's Certificate or Certificates to that effect, dated as of the Closing Date, and signed on behalf of Sheboygan Falls;

(c) Except as set forth in the Disclosure Schedules, there shall have been, between the date hereof and the Closing Date, (i) no Sheboygan Falls Adverse Effect, (ii) no adverse federal, state or local legislative or regulatory change affecting in any material respect the services or business of Sheboygan Falls, (iii) no material damage to any Sheboygan Falls Property or Assets of Sheboygan Falls by fire, flood, casualty, act of God or the public enemy or other cause, regardless of insurance coverage for such damage, so as to impair in any material respect the ability of Sheboygan Falls to render services or continue operations and (iv) no material and adverse development or proceeding affecting Sheboygan Falls' Insurance License in Wisconsin. There shall have been delivered to Donegal Mutual an Officer's Certificate, dated as of the Closing Date, and signed on behalf of Sheboygan Falls by its Chief Executive Officer to the effect that (a) between the date hereof and the Closing Date there has been no such Sheboygan Falls Adverse Effect as stated in clause (i) hereof, (b) no such material damage as stated in clause (iii) hereof, (c) no adverse licensing development as stated in clause (iv) hereof and (d) further stating that nothing has come to the signer's attention, in the course of his activities on behalf of Sheboygan Falls, that causes him to believe that during such period there occurred any adverse federal, state or local legislative or regulatory change affecting in any material respect the services or business of Sheboygan Falls;

(d) Sheboygan Falls shall have increased the membership of its Board of Directors to ten persons and Donegal Mutual shall have received the resignations of four directors of Sheboygan Falls on or prior to the Closing Date and Sheboygan Falls' Board of Directors shall have appointed as directors of Sheboygan Falls, with the prior approval of the Commissioner of Insurance pursuant to Section INS 40.02 of the Wisconsin Administrative

Code, six qualified persons designated by Donegal Mutual as directors of Sheboygan Falls effective as of the Closing Date;

(e) Not later than the Closing Date, Lee F. Wilcox shall have entered into an Employment Agreement with Sheboygan Falls in substantially the form of Appendix D-1 and each of Bradford C. Bailey, Daniel A. Kussart and Janice L. Tupper shall have entered into an Employment Agreement with Sheboygan Falls in substantially the form of Appendix D-2 and, except as provided in such Employment Agreements, Sheboygan Falls shall have no other obligation to any of such persons in respect of his or her employment by Sheboygan Falls or the termination of such employment with the exception of the Restated Deferred Compensation Agreement as amended November 23, 2005 between Sheboygan Falls and Lee F. Wilcox and the Restated Split Dollar Agreement as amended November 23, 2005 between Sheboygan Falls and Lee F. Wilcox;

(f) Not later than the third business day prior to the Closing Date:

(i) Sheboygan Falls shall have received renewals effective as of January 1, 2007 of all of the reinsurance treaties Sheboygan Falls currently has in effect, with the placement and other terms of such renewals to be acceptable to Donegal Mutual in its reasonable discretion; and

(ii) Sheboygan Falls shall have booked for SAP purposes and reflected in its December 31, 2006 Annual Statement all catastrophe reinsurance reinstatements for loss occurrences and commission readjustments through December 31, 2006 and there shall not be any catastrophe reinsurance reinstatements for loss occurrences or commission readjustments not shown on the December 31, 2006 Annual Statement whether arising prior to or after December 31, 2006, that, individually or in the aggregate, would have a Sheboygan Falls Adverse Effect;

(g) The policyholders surplus of Sheboygan Falls, determined in accordance with SAP, shall be not less than \$5,000,000 as of the last day of the month immediately preceding the month in which the Closing occurs;

(h) Sheboygan Falls shall not have made any material expenditures through the Closing Date, except in accordance with its current Board-approved budget; and

(i) Sheboygan Falls shall have delivered to Donegal Mutual a copy of the preliminary report by the OCI of its recent examination of Sheboygan Falls if Sheboygan Falls shall have received such preliminary report prior to the Closing Date and, if not, Sheboygan Falls shall have delivered to Donegal Mutual a written report describing in reasonable detail all issues raised by the OCI during such examination.

6.3 Conditions to Obligations of Sheboygan Falls. The obligation of Sheboygan Falls to sell the Note and to perform its other obligations hereunder to be performed on the

Closing Date shall, at the option of Sheboygan Falls, be subject to the fulfillment on or prior to the Closing Date, of the following conditions:

(a) Donegal Mutual shall have performed or complied in all material respects with all obligations and agreements required to be performed and complied with by it under this Agreement, including the deliveries required by Section 2.3(c), at or prior to the Closing Date and Sheboygan Falls shall have received an Officers' Certificate from Donegal Mutual as to the satisfaction of this condition;

(b) Each of the representations and warranties of Donegal Mutual contained in this Agreement that is qualified by materiality shall be true and correct on the Closing Date as though made on the Closing Date and each of the representations and warranties of Donegal Mutual that is not so qualified shall be true and correct in all material respects on the Closing Date as though made on the Closing Date, other than representations and warranties that address matters only as of a certain date and which shall be true and correct in all material respects as of such certain date, and there shall have been delivered to Sheboygan Falls an Officer's Certificate or Certificates to that effect, dated as of the Closing Date, and signed on behalf of Donegal Mutual;

(c) There shall have been, between the date hereof and the Closing Date, (i) no Donegal Mutual Adverse Effect, (ii) no adverse federal, state or local legislative or regulatory change affecting in any material respect the services or business of Donegal Mutual, (iii) no material damage to any Donegal Mutual Property or Assets of Donegal Mutual by fire, flood, casualty, act of God or the public enemy or other cause, regardless of insurance coverage for such damage, so as to impair in any material respect to the ability of Donegal Mutual to render services or continue operations and (iv) no material and adverse development or proceeding affecting Donegal Mutual's Insurance Licenses. There shall have been delivered to Sheboygan Falls an Officer's Certificate, dated as of the Closing Date, and signed on behalf of Donegal Mutual by its Chief Executive Officer to the effect (a) that between the date hereof and the Closing Date there has been no such Donegal Mutual Adverse Effect as stated in clause (i) hereof, (b) no such material damage as stated in clause (iii) hereof, (c) no adverse licensing development as stated in clause (iv) hereof and (d) further stating that nothing has come to the signer's attention, in the courses of his activities on behalf of Donegal Mutual, that causes him to believe that during such period there occurred any adverse federal, state or local legislative or regulatory change affecting in any material respect the services or business of Donegal Mutual; and

(d) At Closing, Donegal Mutual shall have tendered to Sheboygan Falls payment of the purchase price of the Note as specified in Section 2.2.

ARTICLE VII
TERMINATION

7.1 Termination. This Agreement may be terminated and the purchase and sale of the Note and the other transactions contemplated hereby be abandoned at any time prior to the Closing Date:

(a) by mutual consent of Sheboygan Falls and Donegal Mutual;

(b) by either Sheboygan Falls or Donegal Mutual by one day's written notice to Donegal Mutual or Sheboygan Falls, as the case may be, if the Closing shall not have been consummated on or before April 30, 2007; provided that the right to terminate this Agreement under this Section 7.1(b) shall not be available to any party whose failure to fulfill any obligation under this Agreement has been the cause of, or resulted in, the failure of the purchase and sale of the Note to have been consummated on or before such date;

(c) by either Donegal Mutual or Sheboygan Falls by one day's written notice to Sheboygan Falls or Donegal Mutual, as the case may be, if any of the conditions to such party's obligations to consummate the transactions contemplated by this Agreement shall have become impossible to satisfy; or

(d) by Donegal Mutual if (i) Sheboygan Falls is in breach at any time prior to the Closing Date of any of the representations and warranties made by Sheboygan Falls as though made on and as of such date, unless the inaccuracies (without giving effect to any materiality or material adverse effect qualifications or materiality exceptions contained therein) in such representations and warranties, individually or in the aggregate, have not had and would not reasonably be expected to result in Sheboygan Falls Adverse Effect as to Sheboygan Falls or (ii) Sheboygan Falls shall not have performed and complied in all material respects with all covenants required by this Agreement to be performed or complied with by it on and as of such date, which breach cannot be or has not been cured, in all material respects within 15 days after the giving of written notice thereof by Donegal Mutual to Sheboygan Falls.

(e) by Sheboygan Falls if (i) Donegal Mutual is in breach at any time prior to the Closing Date of any of the representations and warranties made by Donegal Mutual as though made on and as of such date, unless the inaccuracies (without giving effect to any materiality or material adverse effect qualifications or materiality exceptions contained therein) in such representations and warranties, individually or in the aggregate, have not had and would not reasonably be expected to result in a Donegal Mutual Adverse Effect as to Donegal Mutual or (ii) Donegal Mutual shall not have performed and complied in all material respects with all covenants required by this Agreement to be performed or complied with by it on and as of such date, which breach cannot be or has not been cured, in all

material respects within 15 days after the giving of written notice thereof by Sheboygan Falls to Donegal Mutual.

7.2 Effect of Termination. In the event of the termination of this Agreement by either Sheboygan Falls or Donegal Mutual, as provided in Section 7.1, this Agreement shall thereafter become void and there shall be no Liability on the part of any party hereto against any other party hereto, or their respective directors, officers, policyholders or agents, except that (i) any such termination shall be without prejudice to the rights of any party hereto arising out of the willful breach by any other party of any covenant or agreement contained in this Agreement, (ii) Section 5.2 and Article IX shall continue in full force and effect notwithstanding such termination and (iii) each of the parties hereto shall provide the other party hereto with a copy of any proposed public announcement regarding the occurrence of such termination and an opportunity to comment thereon prior to its dissemination.

ARTICLE VIII

AMENDMENT, WAIVER AND INDEMNIFICATION

8.1 Amendment. This Agreement may be amended or modified in whole or in part any time by an agreement in writing executed in the same manner as this Agreement, provided, however, that no amendment shall be made that changes the terms of this Agreement in any material respect and that requires the further approval or proceedings of any insurance Governmental Entity without such approval having first been obtained or such proceedings having been first completed.

8.2 Extension; Waiver. At any time prior to the Closing Date, either party hereto may:

- (a) extend the time for the performance of any of the obligations or other acts of the other party hereto,
- (b) waive any inaccuracies in the representations and warranties contained herein or in any document delivered pursuant hereto, and
- (c) waive compliance with any of the agreements or conditions contained herein.

Any agreement on the part of a party to any such extension or waiver shall be valid only if set forth in an instrument in writing signed on behalf of such party by its President. The failure of any party hereto to enforce at any time any provision of this Agreement shall not be construed to be a waiver of such provision, nor in any way to affect the validity of this Agreement or any part hereof or the right of such party hereafter to enforce each and every

such provision. No waiver of any breach of this Agreement shall be held to constitute a waiver of any other or subsequent breach.

8.3 Survival of Obligations. All certifications, representations and warranties made herein by Sheboygan Falls and Donegal Mutual and their obligations to be performed pursuant to the terms hereof, shall survive the Closing Date hereunder, notwithstanding any notice of any inaccuracy, breach or failure to perform not waived in writing and notwithstanding the consummation of the transactions contemplated herein with knowledge of such inaccuracy, breach or failure. All representations and warranties contained herein shall terminate upon the earlier of (i) repayment in full of the principal amount of the Note and all accrued but unpaid interest thereon or (ii) 90 days after Donegal Mutual shall have received the audited financial statements of Sheboygan Falls for the year ending December 31, 2007; provided that (i) the representations and warranties contained in Section 3.15 shall expire two years after the Closing Date or, with respect to each claim under Section 3.15 arising before or during such two-year period, upon the earlier to occur of (x) such claim's final judicial determination or settlement and satisfaction of any judgment or full payment of any settlement, as the case may be or (y) such time, if any, as the claim shall be barred by the applicable statute of limitations or (z) the payment in full of the Note and (ii) the representations and warranties contained in Section 3.16 shall expire four years after the Closing Date or with respect to any dispute with the IRS upon the earlier to occur of (x) such dispute's final resolution and the payment of all taxes, interests and penalties arising therefrom and (y) the expiration of the applicable statute of limitations.

8.4 Indemnification.

(a) Each party (the "Indemnifying Person") agrees to indemnify and hold harmless the other party and their respective subsidiaries, affiliates, partners, successors and assigns (collectively, the "Indemnified Persons") from and against any and all (x) Liabilities, losses, costs, deficiencies or damages ("Loss") and (y) reasonable attorneys' and accountants' fees and expenses, court costs and all other reasonable out-of-pocket expenses ("Expense") incurred by any Indemnified Person, in each case net of any insurance proceeds received and retained by such Indemnified Person, in connection with or arising from (i) any breach by the Indemnifying Person of any of its covenants in, or any failure of the Indemnifying Person to perform any of its obligations under, this Agreement or (ii) any material breach of any warranty or the material inaccuracy of any representation of the Indemnifying Person contained or referred to in this Agreement or in any Officer's Certificate delivered by or on behalf of the Indemnifying Person pursuant hereto provided that the liability of the Indemnifying Person shall be limited (the "Liability Limit") to an aggregate of Three Million Five Hundred Thousand Dollars (\$3,500,000).

No claim shall be made for indemnity pursuant to this Section 8.4 until the aggregate amount of Loss and Expense incurred by all Indemnified Persons is Fifty Thousand Dollars (\$50,000),

but if the aggregate amount of such Loss and Expense exceeds such amount, the Indemnifying Person shall be liable for all Loss and Expense, including such initial Fifty Thousand Dollars (\$50,000) amount, subject to any applicable Liability Limit. In addition, no claim for indemnity pursuant to this Section 8.4 shall be made by Donegal Mutual in respect of any Liability to the extent that such Liability is reflected on the audited balance sheet of Sheboygan Falls as of the Closing Date.

(b) If any Indemnified Person has suffered or incurred any Loss or incurred any Expense, it shall so notify the Indemnifying Person promptly in writing describing such Loss or Expense, the amount thereof, if known, and the method of computation of such Loss or Expense, all with reasonable particularity and containing a reference to the provision of this Agreement or any Officer's Certificate delivered pursuant hereto in respect of which such Loss or Expense shall have occurred. If any action at law or suit in equity is instituted by or against a third party with respect to which any Indemnified Person intends to claim any liability or expense as Loss or Expense under this Section 8.4, such Indemnified Person shall promptly notify the Indemnifying Person of such action or suit. The failure of an Indemnified Person to promptly notify the Indemnifying Person of a claim as contemplated by the preceding sentence will not relieve the Indemnifying Person of its obligations under this Section 8.4 except to the extent that the Indemnifying Person is prejudiced in its defense of such claim as a result of such failure to give prompt notice.

(c) Subject to paragraph (d) of this Section 8.4, the Indemnified Persons shall have the right to conduct and control, through counsel of their choosing, any third party claim, action or suit and may compromise or settle the same, provided that any of the Indemnified Persons shall give the Indemnifying Person advance notice of any proposed compromise or settlement. The Indemnified Persons shall permit the Indemnifying Person to participate in the defense of any such action or suit through counsel chosen by it, provided that the fees and expenses of such counsel shall be borne by the Indemnifying Person. Any compromise or settlement with respect to a claim for money damages effected after the Indemnifying Person, by notice to the Indemnified Persons, shall have disapproved such compromise or settlement, shall discharge the Indemnifying Person from liability with respect to the subject matter thereof, and no amount in respect thereof shall be claimed as Loss or Expense under this Section 8.4; provided that if the Indemnifying Person shall disapprove of a proposed compromise or settlement of a claim the acceptance of which is recommended by counsel conducting the defense of such claim and the amount of such settlement would exceed an applicable Liability Limit, the Indemnifying Person shall, notwithstanding such Liability Limit, be liable for the full amount of any judgment entered in respect of, or later compromise or settlement approved by the Indemnifying Person of, such claim less the amount by which the proposed compromise or settlement disapproved by the Indemnifying Person exceeded such Liability Limit.

(d) If the remedy sought in any action or suit referred to in paragraph (c) of this Section 8.4 is solely money damages and the sum of (i) the amount claimed in such action or suit, (ii) all amounts previously paid by the Indemnifying Person pursuant to this Section 8.4 and (iii) all amounts claimed in all pending claims for indemnity under this Section 8.4 does not exceed the aggregate liability of the Indemnifying Person under this Section 8.4, the Indemnifying Person shall have 15 business days after receipt of the notice referred to in the last sentence of paragraph (b) of this Section 8.4 to notify the Indemnified Persons that it elects to conduct and control such action or suit. If the Indemnifying Person does not give the foregoing notice, the Indemnified Persons shall have the right to defend, contest, settle or compromise such action or suit in the exercise of their exclusive discretion and the Indemnifying Person shall, upon request from any of the Indemnified Persons, promptly pay to such Indemnified Persons in accordance with the other terms of this Section 8.4 the amount of any Loss resulting from its liability to the third party claimant and all related Expense. If the Indemnifying Person gives the foregoing notice, the Indemnifying Person shall have the right to undertake, conduct and control, through counsel of its own choosing and at its sole expense of the Indemnifying Person, the conduct and settlement of such action or suit, and the Indemnified Persons shall cooperate with the Indemnifying Person in connection therewith; provided that (x) the Indemnifying Person shall not thereby permit to exist any Lien upon any Asset of any Indemnified Person, (y) the Indemnifying Person shall permit the Indemnified Persons to participate in such conduct or settlement through counsel chosen by the Indemnified Persons, but the fees and expenses of such counsel shall be borne by the Indemnified Persons, except as provided in clause (z) hereof and (z) the Indemnifying Person shall agree promptly to reimburse to the extent required under this Section 8.4 the Indemnified Persons for the full amount of any Loss resulting from such action or suit and all related Expense incurred by the Indemnified Persons, except fees and expenses of counsel for the Indemnified Persons incurred after the assumption of the conduct and control of such action or suit by the Indemnifying Person. So long as the Indemnifying Person is contesting any such action or suit in good faith, the Indemnified Persons shall not pay or settle any such action or suit. Notwithstanding the foregoing, the Indemnified Persons shall have the right to pay or settle any such action or suit, provided that in such event the Indemnified Persons shall waive any right to indemnity therefor by the Indemnifying Person and no amount in respect thereof shall be claimed as Loss or Expense under this Section 8.4.

ARTICLE IX

MISCELLANEOUS

9.1 Notices. All notices or other communications required or permitted hereunder shall be in writing and shall be given by confirmed facsimile or registered mail, postage prepaid, addressed as follows:

if to Donegal Mutual, to:

Donegal Mutual Insurance Company
1195 River Road
Marietta, Pennsylvania 17547
Attention: Donald H. Nikolaus, President
Facsimile: 717-426-7009

with a copy to:

Duane Morris LLP
30 South 17th Street
Philadelphia, Pennsylvania 19103-4196
Attention: Frederick W. Dreher, Esq.
Facsimile: 215-979-1213

if to Sheboygan Falls, to:

Sheboygan Falls Mutual Insurance Company
511 Water Street
Sheboygan Falls, WI 53085-0159
Attention: Lee F. Wilcox, President
Facsimile: 920-467-3364

with a copy to:

Parrett & O'Connell, LLP
10 East Doty Street, Suite 621
Madison, WI 53703
Attention: Connie L. O'Connell
Facsimile: 608-251-1996

or to such other address or facsimile number as the Person to whom notice is given may have previously furnished to the other party in writing in accordance herewith.

9.2 Expenses. Except as otherwise provided herein, each party hereto shall pay its own expenses including, without limitation, legal and accounting fees and expenses incident to its negotiation and preparation of this Agreement and to its performance and compliance with the provisions contained herein. Donegal Mutual shall be solely responsible for the fees and expenses of Sanders.

9.3 Governing Law. This Agreement and the Note shall be governed by and construed in accordance with the laws of the State of Wisconsin without regard to its rules on conflicts of law.

9.4 Successors and Assigns. This Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns, provided that the rights of Sheboygan Falls herein may not be assigned and the rights of Donegal Mutual may be assigned only (a) to such other business organization that shall succeed to substantially all the assets, liabilities and business of Donegal Mutual or (b) to a wholly owned subsidiary of Donegal Mutual, in which event such assignment shall not relieve Donegal Mutual of any of Donegal Mutual's obligations to Sheboygan Falls under this Agreement. Nothing in this Agreement, expressed or implied, is intended to confer upon any other Person any rights or remedies of any nature under or by reason of this Agreement.

9.5 Partial Invalidity. In case any one or more of the provisions contained herein shall, for any reason, be held to be invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provision of this Agreement, but this Agreement shall be construed as if such invalid, illegal or unenforceable provision or provisions had never been contained herein unless the deletion of such provision or provisions would result in such a material change as to cause completion of the transactions contemplated herein to be unreasonable or materially and adversely frustrate the objectives of the parties as expressed in this Agreement.

9.6 Execution in Counterparts. This Agreement may be executed in two counterparts, both of which shall be considered one and the same agreement, and shall become a binding agreement when one or more counterparts have been signed by each of the parties and delivered to the other party.

9.7 Titles and Headings. Titles and headings to Articles and Sections herein are inserted for convenience of reference only and are not intended to be a part of or to affect the meaning or interpretation of this Agreement.

9.8 Entire Agreement; Statements as Representations. This Agreement, together with the Note, the Services Agreement, the Technology License Agreement, the Retrocessional Reinsurance Agreement, the Amended and Restated Bylaws, the Disclosure Schedules, the Existing Confidentiality Agreements and any documents delivered pursuant to Articles II and VI, contains the entire understanding of the parties hereto with regard to the subject matter contained herein. All statements contained in this Agreement or in any schedule, exhibit, certificate, list or other document delivered pursuant to this Agreement shall be deemed representations and warranties as such terms are used in this Agreement.

9.9 Specific Performance. Each of the parties hereto acknowledges and agrees that the other party hereto would be irreparably damaged in the event any of the provisions of

this Agreement were not performed in accordance with their specific terms or were otherwise breached. Accordingly, each of the parties hereto agrees that they each shall be entitled to an injunction or injunctions to prevent breaches of the provisions of this Agreement and to enforce specifically this Agreement and the terms and provisions hereof in any action instituted in any court of the United States or any state thereof having subject matter jurisdiction, in addition to any other remedy to which Sheboygan Falls or Donegal Mutual may be entitled, at law or in equity.

IN WITNESS WHEREOF, each party hereto has caused this Agreement to be executed on its behalf as of the date first above written.

DONEGAL MUTUAL INSURANCE COMPANY

By: /s/ Donald H. Nikolaus

Donald H. Nikolaus, President

SHEBOYGAN FALLS MUTUAL INSURANCE
COMPANY

By: /s/ Lee F. Wilcox

Lee F. Wilcox, President

AMENDMENT NO. 1 TO CONTRIBUTION NOTE PURCHASE AGREEMENT

THIS AMENDMENT NO. 1 (this "Amendment") made and entered into as of this 9th day of May 2007 to the Contribution Note Purchase Agreement (the "Agreement") made and entered into as of December 27, 2006 between Donegal Mutual Insurance Company, a Pennsylvania mutual fire insurance company ("Donegal Mutual") and Sheboygan Falls Mutual Insurance Company, a Wisconsin mutual fire and casualty insurance company ("Sheboygan Falls"). All capitalized terms used herein but not defined herein shall have the respective meanings assigned to them in the Agreement.

WITNESSETH:

WHEREAS, Section 7.1(b) of the Agreement provides that either Donegal Mutual or Sheboygan Falls may, by one day's written notice to the other, terminate the Agreement if the Closing shall not have been consummated on or before April 30, 2007;

WHEREAS, all Required Filings and Approvals to consummation of the Closing have not been obtained as of the date of this Agreement and it appears unlikely to Donegal Mutual and Sheboygan Falls that all Required Filings and Approvals will be obtained by April 30, 2007; and

WHEREAS, Donegal Mutual and Sheboygan Falls desire to amend the Agreement to change the date of April 30, 2007 as set forth in Section 7.1(b) of the Agreement to May 31, 2007 and to ratify and confirm in all other respects all of the agreements, covenants, representations and warranties and conditions contained in the Agreement;

NOW, THEREFORE, Donegal Mutual and Sheboygan Falls, in consideration of the agreements, covenants, representations and warranties and conditions contained in the Agreement and this Amendment, covenants and agree as follows:

1. Amendment and Restatement of Section 7.1(b) of the Agreement. Section 7.1(b) of the Agreement is hereby amended and restated so that, as amended and restated, Section 7.1(b) of the Agreement shall read in its entirety as follows:

"(b) by either Sheboygan Falls or Donegal Mutual by one day's written notice to Donegal Mutual or Sheboygan Falls, as the case may be; if the Closing shall not have been consummated on or before May 31, 2007; provided that the right to terminate this Agreement under this Section 7.1(b) shall not be available to any party whose failure to fulfill any obligation under this Agreement has been the cause of, or resulted in, the failure of the purchase and sale of the Note to have been consummated on or before such date."

2. Confirmation and Ratification of Remainder of the Agreement. Except as specifically provided in Section 1 of this Amendment, all of the agreements, covenants, representations and warranties and conditions contained in the Agreement are hereby expressly confirmed and ratified and shall remain in full force and effect.

3. Representations and Warranties.

(a) Donegal Mutual hereby represents and warrants to Sheboygan Falls that this Amendment has been duly executed and delivered by Donegal Mutual and no further corporate authorization is required on the part of Donegal Mutual in order to consummate the amendment and restatement of the Agreement contemplated by this Amendment.

(b) Sheboygan Falls hereby represents and warrants to Donegal Mutual that this Amendment has been duly executed by Sheboygan Falls and no further corporate authorization is required on the part of Sheboygan Falls in order to consummate the amendment and restatement of the Agreement contemplated by this Amendment.

IN WITNESS WHEREOF, each party has caused this Amendment to be executed on its behalf as of the date first above written.

DONEGAL MUTUAL INSURANCE COMPANY

By: /s/ Donald H. Nikolaus

Donald H. Nikolaus, President

SHEBOYGAN FALLS MUTUAL INSURANCE
COMPANY

By: /s/ Lee F. Wilcox

Lee F. Wilcox, President

PLAN OF CONVERSION
OF
SHEBOYGAN FALLS MUTUAL INSURANCE COMPANY
Under Section 4m of Chapter 611.76 of the Wisconsin Statutes

ARTICLE I
DEFINITIONS

As used in this Plan of Conversion, the following terms have the following meanings:

“Acquisition” means the acquisition of all of the capital stock of SFS by DGI.

“Adoption Date” means October 14, 2008, the date on which the Board approved and adopted this Plan.

“Application” has the meaning specified in Section 3(a) of Chapter 611.76 of the Wisconsin Statutes.

“Appraisal Committee” means Randy Blumer, Brian J. Hogan and Richard J. Kreintz, the three persons appointed by the Commissioner pursuant to Section 3(c) of Chapter 611.76 of the Wisconsin Statutes to determine the value of SFM as of the Effective Date of the Conversion.

“Board” means the Board of Directors of SFM.

“Certificate of Authority” means the certificate of authority to engage in the insurance business to be issued to SFS by OCI pursuant to Section 9 of Chapter 611.76 of the Wisconsin Statutes.

“Commissioner” means the Commissioner of Insurance of the State of Wisconsin.

“Contract Rights” means an Owner’s right to receive (i) the insurance coverage specified in such Owner’s Policy in accordance with the terms and provisions thereof and (ii) dividends, if any, as and when declared by the Board in accordance with the terms and provisions of each Owner’s Policy and other distributions upon liquidation or conversion.

“Contribution Note” means the contribution note in the principal amount of \$3.5 million issued by SFM to DM.

“Conversion” means the conversion of SFM from a Wisconsin-domiciled mutual insurance company into SFS, a Wisconsin-domiciled stock insurance corporation, pursuant to Section 4m of Chapter 611.76 of the Wisconsin Statutes.

“Conversion Resolutions” has the meaning specified in Section 2.1(a).

“Demutualization Committee” means the committee of the Board formed in October 2007 that is comprised of the four members of the Board (Kenneth F. Maurer, James H. Fasse, Thomas A. Scribner and Lee F. Wilcox) who have no affiliation with DM and DGI.

“DGI” means Donegal Group Inc., an insurance holding company organized and existing under the laws of the State of Delaware.

“DM” means Donegal Mutual Insurance Company, a mutual fire insurance company organized and existing under the laws of the Commonwealth of Pennsylvania.

“Effective Date” means the date on which the Conversion occurs as provided in Section 9 of Chapter 611.76 of the Wisconsin Statutes. It is the intent of SFM that the Effective Date be 12:01 a.m., Central Standard Time, on December 1, 2008.

“Eligible Policyholder” means a SFM policyholder entitled to such policyholder’s equitable share in the Value of SFM as determined in accordance with Section 4m(a) of Chapter 611.76 of the Wisconsin Statutes.

“Equitable Share” has the meaning specified in Section 4m(a) of Chapter 611.76 of the Wisconsin Statutes.

“Hearing” means the public hearing to be held by OCI to present evidence and argument relevant to the fairness and equity of this Plan as specified in Section 6(a) of Chapter 611.76 of the Wisconsin Statutes.

“In Force” means a Policy that was in effect on a given date. This determination is made in accordance with Section 6.3 and is based on SFM’s records.

“Note Purchase Agreement” means the Contribution Note Purchase Agreement dated as of December 27, 2006 between SFM and DM.

“OCI” means the Office of the Commissioner of Insurance of the State of Wisconsin, or such governmental officer, body or authority as becomes the primary regulator of SFM and SFS under applicable Wisconsin law.

“Owner” means the Person or Persons who, as determined by the records of SFM, the Restated Articles of Incorporation of SFM and the Amended and Restated Bylaws of SFM, were holders of an In Force Policy on April 30, 2008 or who paid premiums to SFM within the five years prior to April 30, 2008 and as further specified or determined in accordance with Section 6.2.

“Ownership Interest” means a Person’s rights as an Owner. These rights include all rights arising prior to the Effective Date under the Restated Articles of Incorporation of SFM

and the Amended and Restated Bylaws of SFM and as otherwise provided under Wisconsin law through ownership or issuance of a Policy or Policies by SFM, excluding Contract Rights and any other right or interest conferred solely by and under the terms and conditions of a Policy. Such Ownership Interest rights include (i) Voting Rights and (ii) any rights of an Owner to the return of the surplus of SFM that may exist with regard to the surplus not apportioned or declared by the Board as divisible surplus, including rights of an Owner to a distribution of such surplus in dissolution or conversion proceedings under Chapter 611 of the Wisconsin Statutes.

“Person” means an individual, corporation, limited liability company, joint venture, partnership, association, trust, trustee, unincorporated entity or any other form of organization or government or any department or agency thereof. A Person who is the Owner of Policies in more than one legal capacity, e.g., a trustee under separate trusts, shall be deemed to be a separate Person in each such capacity.

“Plan” means this Plan of Conversion of SFM submitted to OCI pursuant to Section 4m of Chapter 611.76 of the Wisconsin Statutes as it may be amended from time to time or withdrawn in accordance with Section 7.3.

“Policy” has the meaning specified in Section 6.1.

“Policyholders Information Statement” means the document summarizing this Plan and containing information relevant to the Hearing, the Special Meeting and the Conversion that will be mailed to the Voting Policyholders in connection with the notice required by Section 6 of Chapter 611.76 of the Wisconsin Statutes.

“SFM” means the Wisconsin-domiciled mutual insurance company named Sheboygan Falls Mutual Insurance Company.

“SFS” means Sheboygan Falls Insurance Company as reorganized as and converted to the Wisconsin-domiciled stock insurance corporation named Sheboygan Falls Insurance Company.

“Special Meeting” has the meaning specified in Section 4.1(a).

“Value” has the meaning specified in Section 5.1(a).

“Voting Policyholder” means the policyholders entitled to vote at the Special Meeting in accordance with Section 8 of Chapter 611.76 of the Wisconsin Statutes.

“Voting Right” means the right of the holder of an In Force Policy to vote for the election of directors of SFM at the annual meeting of policyholders and to vote on other matters pursuant to the Restated Articles of Incorporation of SFM and the Amended and Restated Bylaws of SFM.

ARTICLE II
THE CONVERSION

2.1 The Conversion.

(a) The Board approved resolutions determining that the Conversion is in the best interests of the current and future policyholders of SFM and specifying the reasons therefor and the purposes of the Conversion, and the manner in which the Conversion is expected to benefit the policyholders at a meeting duly called and held on April 30, 2008 (the "Conversion Resolutions").

(b) Under this Plan, SFM shall convert into SFS, a Wisconsin-domiciled stock insurance corporation and all Ownership Interests shall terminate on the Effective Date. Upon the Conversion, each Eligible Policyholder shall have the right to receive cash in an amount equal to the Equitable Share of such Eligible Policyholder in the Value of SFM.

(c) While the Ownership Interests shall terminate and be extinguished upon the Effective Date, the Conversion in and of itself shall not, in any way, alter the Contract Rights, including but not limited to, the premiums due in respect of a Policy that is In Force, reduce the benefits under a Policy that is In Force or otherwise diminish the obligations of SFS as the successor to SFM to the holders of In Force Policies.

2.2 Conditions Precedent. The effectiveness of the Conversion and the Acquisition shall be subject to the satisfaction, or waiver by DM and SFM if legally permitted, of the following conditions in each case in accordance with applicable provisions of Chapter 611.76 of the Wisconsin Statutes:

- (i) the approval of the Conversion and other transactions that are contemplated by this Plan by OCI;
- (ii) the approval of this Plan by the Voting Policyholders of SFM; and
- (iii) DGI shall have made the payments and the contributions to SFS in accordance with subsections (b) and (c) of Section 5.4.

ARTICLE III
ACTIONS BY SHEBOYGAN FALLS MUTUAL

3.1 Application. SFM shall file an Application with OCI requesting approval of the Conversion and the other transactions contemplated by this Plan. The Application shall include the following:

- (a) the Conversion Resolutions certified by the Secretary of SFM;

- (b) this Plan;
- (c) the form of notice of the Hearing;
- (d) the form of notice of the Special Meeting;
- (e) the form of proxy to be solicited from the Voting Policyholders with respect to the Conversion;
- (f) the Policyholders Information Statement to be mailed to the Voting Policyholders;
- (g) a Form D Statement filing with respect to the exchange of the Contribution Note for the shares of SFS;
- (h) the proposed Articles of Incorporation of SFS;
- (i) the proposed Bylaws of SFS;
- (j) a projection of the planned or anticipated financial situation of SFS for five years after the Conversion; and
- (k) any other information or documentation required or requested by OCI to make the findings required by Section 5(c) of Chapter 611.76 of the Wisconsin Statutes.

3.2 Notice of the Hearing.

(a) SFM, at its expense, shall mail written notice of the Hearing, in a form satisfactory to OCI, by first-class mail, postage prepaid, to each Voting Policyholder at the address of such Voting Policyholder as it appears in the books of SFM, except in instances where mailing of notice is not feasible as determined by OCI, and other interested persons as determined by OCI, not less than 10 nor more than 30 days prior to the date of the Hearing. Such notice shall be accompanied or preceded by the Policyholders Information Statement containing information relevant to the Hearing and the Conversion, including the time, date, place and purpose of the Hearing, all of which shall be in a form satisfactory to OCI.

(b) SFM shall also post the notice of the Hearing, the form of proxy and the Policyholders Information Statement on SFM's website. Such website posting shall be made not later than the date of mailing of the written notice of the Hearing and shall be in a form satisfactory to OCI.

ARTICLE IV APPROVAL BY VOTING POLICYHOLDERS

4.1 Policyholder Vote.

(a) If OCI approves this Plan, promptly thereafter, SFM shall hold a special meeting of its Voting Policyholders (the “Special Meeting”) as required by Section 8 of Chapter 611.76 of the Wisconsin Statutes. At the Special Meeting, the Voting Policyholders shall be entitled to vote on the proposal to approve the Conversion and the other transactions contemplated by this Plan. Each Voting Policyholder shall be entitled to vote by proxy or in person at the Special Meeting.

(b) The Conversion and the other transactions contemplated by this Plan are subject to approval by the affirmative vote of not less than two-thirds of the votes of the Voting Policyholders cast thereon by proxy or in person at the Special Meeting.

(c) Each Voting Policyholder shall be entitled to one vote, regardless of the number of Policies or amount of insurance held by or issued to such Voting Policyholder. Two or more Persons who are the Owners of a single Policy and who are one Owner shall be deemed one Voting Policyholder for purposes of voting and shall collectively be entitled to one vote as provided in the Amended and Restated Bylaws of SFM.

4.2 Notice of Special Meeting.

(a) SFM shall, at its expense, mail notice of the Special Meeting by first-class mail, postage prepaid, to all Voting Policyholders as provided in this Plan. The notice shall set forth the purposes of the Special Meeting and the time, date and place of the Special Meeting, and shall enclose a form of proxy for each Voting Policyholder. Such notice and proxy shall be mailed to the address of each Voting Policyholder as it appears in the records of SFM, except in instances where mailing of notice is not feasible as determined by OCI. Such notice period for the Special Meeting may run concurrently with the notice period for the Hearing as provided in Section 3.2.

(b) Such notice of the Special Meeting shall be accompanied by the Policyholders Information Statement, which shall contain information relevant to the Special Meeting, including a copy of this Plan and other explanatory information, all of which shall be in a form satisfactory to OCI.

(c) SFM shall post the notice of the Special Meeting and the Policyholders Information Statement on SFM’s website. Such posting shall be made not later than the first mailing of the written notice of the Special Meeting and shall be in a form satisfactory to OCI.

ARTICLE V THE CONVERSION

5.1 Effect of the Conversion.

(a) On the Effective Date and subject to the satisfaction of the conditions precedent in Section 2.2, SFM shall be converted from a mutual insurance company into a

stock insurance corporation in accordance with Section 9 of Chapter 611.76 of the Wisconsin Statutes, and each Eligible Policyholder, as compensation for the extinguishment of such Eligible Policyholder's Ownership Interests in SFM as of the Effective Date, shall receive an amount in cash equal to the Equitable Share of such Eligible Policyholder in the value of SFM as determined by the Appraisal Committee as of the Effective Date of the Conversion as provided in Section 4m of Chapter 611.76 of the Wisconsin Statutes after the payment of all costs incurred by SFM in connection with this Plan (the "Value"). The payment to each Eligible Policyholder shall be determined by the ratio that the net premiums such Eligible Policyholder has properly and timely paid to SFM on insurance policies in effect during the five years immediately preceding April 30, 2008 bears to the total net premiums received by SFM by all Eligible Policyholders during that five-year period times the Value.

(b) SFM shall file the Amended and Restated Articles of Incorporation of SFS in the form of Appendix A to this Plan and the Amended and Restated Bylaws of SFS in the form of Appendix B to this Plan with OCI no later than the day before the Effective Date.

5.2 Effectiveness of this Plan.

(a) The Effective Date of this Plan shall be the date on which OCI issues a Certificate of Authority to SFS pursuant to Section 9 of Chapter 611.76 of the Wisconsin Statutes.

(b) Upon the Effective Date:

(i) SFM shall become a stock insurance corporation by operation of Chapter 611 of the Wisconsin Statutes.

(ii) All Ownership Interests shall terminate and be extinguished and the Eligible Policyholders shall be entitled to receive in exchange therefor the cash payment provided in Section 5.3(a).

(iii) The Articles of Incorporation of SFS in the form of Appendix A to this Plan shall become effective.

(iv) The Bylaws of SFS in the form of Appendix B to this Plan shall become effective.

(v) SFS shall be a continuation of SFM and the Conversion shall not annul or modify any of SFM's existing suits, contracts or liabilities, except as expressly provided in this Plan. All rights, franchises and interests of SFM in and to property, assets and other interests shall be transferred by operation of law and vest in SFS, and SFS shall, by operation of law, assume all obligations and liabilities of SFM other than those terminated and extinguished by the effectiveness of this Plan. Appropriate changes to reflect the Conversion shall also be made to the insurance policies and other forms to be used by SFS.

In all other respects, the terms and conditions of the SFM policies will remain substantially unchanged.

(vi) SFS shall exercise all rights and powers and shall perform all duties conferred or imposed by law on insurance corporations writing the classes of insurance written by it, and shall retain its rights and contracts existing before the Conversion, subject to the express provisions of this Plan.

(vii) The directors and officers of SFM immediately prior to the Effective Date shall continue in office as the initial directors and officers of SFS until their respective successors are elected or appointed pursuant to the Amended and Restated Articles of Incorporation in the form of Appendix A to this Plan and the Amended and Restated Bylaws of SFS in the form of Appendix B to this Plan or until their earlier resignation, removal or death.

5.3 Payment of Equitable Share of the Value to the Eligible Policyholders.

(a) The Equitable Share of the Value to be paid to the Eligible Policyholders in exchange for the termination and extinguishment of their Ownership Interests shall be a one-time cash payment. This cash payment will be made by SFS to the Eligible Policyholders within 75 days after SFM has received a Form W-9 from such Eligible Policyholder, unless OCI approves a later date.

(b) OCI retained StoneRidge Advisors, LLC, an independent investment banking firm, to assist the Appraisal Committee in its determination of the Value of SFM and approved the retention by SFM of North Avenue Associates as an independent real estate appraiser, to assist the Appraisal Committee in its determination of the fair market value of the real estate owned by SFM.

5.4 Acquisition of Capital Stock by DGI.

(a) On the Effective Date, DGI will purchase the Contribution Note from DM, and DM will sell the Contribution Note to DGI, for the principal amount thereof and the accrued but unpaid interest thereon. DGI will thereupon exchange the Contribution Note and the accrued but unpaid interest thereon for the issuance to DGI of one share of common stock, par value \$1.00 per share, of the authorized capital stock of SFS for each \$1.00 of the principal amount of, and accrued interest on, the Contribution Note, and DGI will return the Contribution Note to SFS marked "cancelled."

(b) On the Effective Date, DGI will make an additional capital contribution to SFS so that SFS's surplus, after the payment of the Value to the Eligible Policyholders as set forth in Section 5.3 and conversion of the Contribution Note as contemplated in Section 5.4(b), shall be no less than \$10.5 million.

(c) On the Effective Date, DGI shall assume and be bound by the covenants of DM set forth in Section 5.9 of the Note Purchase Agreement to the same extent as if DGI had been an original party to the Note Purchase Agreement in lieu of DM.

ARTICLE VI
POLICIES

6.1 Policies. For the purposes of this Plan, the term “Policy” means each original insurance policy that has been issued or assumed by SFM.

6.2 Determination of Ownership. The Owner of any Policy as of any date specified in this Plan shall be determined by SFM on the basis of its records as of such date in accordance with the following provisions:

(a) The Owner of a Policy shall be the holder of the Policy as shown in the records of SFM, as described with greater particularity in the remainder of this Section 6.2.

(b) If an individual Policy contains ownership provisions and an Owner is named therein, then the Owner is the Person named as such in the Policy as shown in the records of SFM.

(c) If an individual Policy does not contain ownership provisions, or contains such provisions but an Owner is not named therein, the owner of the property insured by the Policy, as shown in the records of SFM, shall be the Owner.

(d) Except as otherwise set forth in this Article VI, the identity of the Owner of a Policy shall be determined without giving effect to any interest of any other Person in such Policy.

(e) In any situation not expressly covered by the foregoing provisions of this Section 6.2, the policyholder, as reflected on the records of, and as determined in good faith by, SFM shall, subject to the contrary decision of OCI pursuant to Section 6.2(g), conclusively be presumed to be the Owner of such Policy for purposes of this Section 6.2, and, except for administrative errors, SFM shall not be required to examine or consider any other facts or circumstances.

(f) The mailing address of an Owner as of any date for purposes of this Plan shall be the Owner’s last known address as shown in the records of SFM as of such date.

(g) Any dispute as to the identity of the Owner of a Policy or the right to vote on this Plan or receive the one-time cash payment shall be resolved in accordance with the foregoing and such other procedures as may be acceptable to OCI.

6.3 In Force. A Policy shall be deemed to be In Force as of any date for the purposes of this Plan if, as shown in SFM's records:

(a) As of such date, such Policy has been issued and remains in effect;

(b) As of such date, such Policy has been terminated but the effective date of the termination is subsequent to such date;

(c) As of such date, SFM has received an application, complete on its face, together with all required underwriting information and payment of the full initial premium for a Policy with an inception date on or before such date and such Policy has not terminated or been terminated with a date of termination effective prior to such date; or

(d) A binder for a Policy with an inception date on or before such date has been issued, even though full consideration for the Policy has not yet been received by SFM and the binder has not terminated or been terminated with a date of termination effective prior to such date.

Any policy referred to in clauses (c) and (d) shall be deemed In Force if such Policy is issued as applied for and delivered in accordance with the terms of the application or binder.

ARTICLE VII ADDITIONAL PROVISIONS

7.1 No Compensation to Directors, Officers, Agents and Employees. No director, officer, agent or employee of SFM shall receive any fee, commission or other valuable consideration whatsoever from SFM or SFS, other than their usual salary and compensation, for in any manner aiding, promoting or assisting in the Conversion, except as provided for herein or as approved by OCI.

7.2 Notices. If SFM complies substantially and in good faith with the requirements of this Plan and applicable provisions of the Wisconsin Statutes with respect to the giving of any required notice to the Voting Policyholders, its failure in any case to give such notice to any Person or Persons entitled thereto shall not impair the validity of the actions and proceedings taken under this Plan or Chapter 611 of the Wisconsin Statutes or entitle such Person to any injunctive or other equitable relief with respect thereto.

7.3 Amendment or Withdrawal of this Plan. At any time prior to the Effective Date, the Board may, upon the recommendation of the Demutualization Committee, withdraw or, with OCI's approval, amend this Plan. Nothing herein shall be construed to prevent SFM from amending its Restated Articles of Incorporation and Amended and Restated Bylaws in accordance with their respective terms and applicable law.

7.4 Corrections. SFM may, until the Effective Date, by an instrument executed by its President, attested by its Secretary under its corporate seal and submitted to OCI, make such modifications to this Plan as are appropriate to correct errors, clarify existing items or make additions to correct manifest omissions in this Plan.

7.5 Costs and Expenses; Indemnification.

(a) All reasonable costs incurred by SFM related to this Plan and the transactions that are a part of the Conversion, including, without limitation, those costs attributable to the use of outside advisors by SFM, the Demutualization Committee, the Appraisal Committee, including the reasonable compensation of its members if so authorized by OCI, and OCI, shall be borne by SFM and such costs shall be subtracted from the value determined by the Appraisal Committee.

(b) SFM shall also indemnify each member of the Appraisal Committee and shall hold each such member harmless against any threatened or actual claim, action, suit, proceeding or investigation, whether civil, criminal or investigative, in which such member is or is threatened to be made a party based in whole or in part out of, or pertaining to (i) the fact that member is or was a member of the Appraisal Committee or (ii) the Plan or any transaction contemplated by this Plan.

7.6 Interpretation of this Plan. Subject to the provisions of Chapter 611 of the Wisconsin Statutes and, absent a contrary determination from OCI, the Chief Executive Officer of SFM or his designee shall have the power to interpret and construe this Plan and to determine all questions of eligibility, status and rights of Policies, Owners, Ownership Interests, Voting Policyholders, Eligible Policyholders and others. SFM recognizes that unforeseen circumstances may occur and questions may arise that are not specifically addressed by any provision of this Plan or applicable Wisconsin law, and the Chief Executive Officer of SFM or his designee shall have the right to resolve such questions when they do arise, absent a contrary determination by OCI. The determination of the Chief Executive Officer of SFM or his designee in all matters described in this Section 7.6 within his province shall be binding and conclusive.

7.7 Governing Law. The terms of this Plan shall be governed by and construed in accordance with the laws of the State of Wisconsin.

IN WITNESS WHEREOF, SFM, by authority of the Board, has caused this Plan to be duly executed as of this 14th day of October, 2008.

SHEBOYGAN FALLS MUTUAL
INSURANCE COMPANY

By: /s/ Lee F. Wilcox
Lee F. Wilcox, President

SELECTED Consolidated Financial Data

Year Ended December 31,	2008	2007	2006	2005	2004
Income Statement Data					
Premiums earned	\$346,575,266	\$310,071,534	\$301,478,162	\$294,498,023	\$265,838,594
Investment income, net	22,755,784	22,785,252	21,320,081	18,471,963	15,906,728
Realized investment (losses) gains	(2,970,716)	2,051,050	1,829,539	1,802,809	1,466,220
Total revenues	372,312,162	340,618,294	329,967,034	319,847,194	287,788,638
Income before income taxes and extraordinary gain	32,092,044	52,848,938	56,622,263	52,345,495	37,054,251
Income taxes	6,550,066	14,569,033	16,407,541	15,395,998	10,885,652
Extraordinary gain	—	—	—	—	5,445,670
Net income	25,541,978	38,279,905	40,214,722	36,949,497	31,614,269
Basic earnings per share - Class A	1.03	1.55	1.65	1.57	1.38
Diluted earnings per share - Class A	1.02	1.53	1.60	1.51	1.32
Cash dividends per share - Class A	.42	.36	.33	.30	.27
Basic earnings per share - Class B	.92	1.39	1.48	1.41	1.25
Diluted earnings per share - Class B	.92	1.39	1.48	1.41	1.24
Cash dividends per share - Class B	.37	.31	.28	.26	.24
Balance Sheet Data at Year End					
Total investments	\$632,135,526	\$605,869,587	\$591,337,674	\$547,746,114	\$499,069,332
Total assets	880,109,036	834,095,576	831,697,811	781,421,588	735,415,401
Debt obligations	15,465,000	30,929,000	30,929,000	30,929,000	30,929,000
Stockholders' equity	363,583,865	352,690,191	320,802,262	277,896,186	242,704,314
Book value per share	14.29	13.92	12.70	11.30	10.15



FINANCIAL Information

Management’s Discussion and Analysis of Results of Operations and Financial Condition	10
Consolidated Balance Sheets	19
Consolidated Statements of Income and Comprehensive Income	20
Consolidated Statements of Stockholders’ Equity	21
Consolidated Statements of Cash Flows	22
Notes to Consolidated Financial Statements	23
Report of Independent Registered Public Accounting Firm — Consolidated Financial Statements	38
Management’s Report on Internal Control Over Financial Reporting	39
Report of Independent Registered Public Accounting Firm — Internal Control Over Financial Reporting	40
Comparison of Total Return on Our Common Stock with Certain Averages	41
Corporate Information	42



MANAGEMENT'S Discussion and Analysis of Results of Operations and Financial Condition

General

Donegal Mutual Insurance Company ("Donegal Mutual") organized us as an insurance holding company on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars"), the Peninsula Insurance Group ("Peninsula"), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, and Sheboygan Falls Insurance Company ("Sheboygan"), write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwest and Southern states. We acquired Sheboygan on December 1, 2008, and Sheboygan's results of operations have been included in our consolidated results from that date. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies. We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a thrift holding company. Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

At December 31, 2008, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

In April 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 33 $\frac{1}{3}$ % stock dividend to stockholders of record at the close of business on April 17, 2006 and paid on April 26, 2006.

In March 2007, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission (SEC) Rule 10b-18 and in privately negotiated transactions. We purchased 214,343 and 266,426 shares of our Class A common stock under this program during 2008 and 2007, respectively.

In June 2007, Donegal Mutual consummated an affiliation with Sheboygan. As part of the affiliation, Donegal Mutual made a \$3.5 million contribution note investment in Sheboygan. During 2008, Sheboygan's board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired Sheboygan as of December 1, 2008 for approximately \$12.0 million in cash, including payment of the contribution note and accrued interest to Donegal Mutual.

In February 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions.

Pooling Agreement and Other Transactions with Affiliates

In the mid-1980s, Donegal Mutual, like a number of other mutual property and casualty insurance companies, recognized the need to develop additional sources of capital and surplus to remain competitive and to have the capacity to expand its business and assure its long-term viability. Donegal Mutual, again like a number of other mutual property and casualty insurance companies, determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company, then wholly owned by Donegal Mutual, and caused us to form Atlantic States as our wholly owned subsidiary. As part of the implementation of this strategy, Donegal Mutual and Atlantic States entered into a pooling agreement in 1986. Under this pooling agreement, Donegal Mutual and Atlantic States pool substantially all of their respective premiums, losses and expenses. Each company then receives an allocation of the pooled business. The consideration to Donegal Mutual for entering into the pooling agreement was its ownership of our capital stock and the expectation that Donegal Mutual's surplus would increase over time as the value of its ownership interest in us increased.

Since 1986, we have completed three public offerings. A major purpose of those offerings was to provide capital for Atlantic States and our other insurance subsidiaries and to fund acquisitions. As the capital of Atlantic States increased, its underwriting capacity increased proportionately. Thus, as originally planned in the mid-1980s, Atlantic States has had access to the capital necessary to support the growth of its direct business and increases in the amount and percentage of business it assumes from the underwriting pool with Donegal Mutual. As a result, the participation of Atlantic States in the inter-company pool has increased over the years from its initial 35% participation in 1986 to its 80% participation in 2008, and the size of the pool has increased substantially. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the pooled business to 80%.

The risk profiles of the business Atlantic States and Donegal Mutual write have historically been, and continue to be, substantially similar. The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries.

In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products offered by our insurance subsidiaries and Donegal Mutual are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the underwriting pool, Donegal Mutual and Atlantic States share the underwriting results in proportion to

their respective participation in the pool. We realize 80% of the underwriting results of the pool because of the 80% participation of Atlantic States in the underwriting pool. The business Atlantic States derives from the pool represents the predominant percentage of our total revenues. See Note 3 — Transactions with Affiliates for more information regarding the pooling agreement.

In addition to the pooling agreement and third-party reinsurance, our insurance subsidiaries have various reinsurance arrangements with Donegal Mutual. These agreements include:

- catastrophe reinsurance agreements with Atlantic States, Le Mars and Southern;
- an excess of loss reinsurance agreement with Southern;
- a quota-share reinsurance agreement with Peninsula; and
- a quota-share reinsurance agreement with Southern.

The intent of the excess of loss and catastrophe reinsurance agreements is to lessen the effects of a single large loss, or an accumulation of smaller losses arising from one event, to levels that are appropriate given each subsidiary's size, underwriting profile and surplus position.

Donegal Mutual and Peninsula have a quota-share reinsurance agreement that transfers to Donegal Mutual 100% of the premiums and losses related to the workers' compensation product line of Peninsula Indemnity Company, which provides the availability of an additional workers' compensation tier to Donegal Mutual's commercial accounts.

The intent of the quota-share reinsurance agreement with Southern is to transfer to Southern 100% of the premiums and losses related to certain personal lines products offered in Virginia by Donegal Mutual through the use of its automated policy quoting and issuance system.

Until December 31, 2006, Donegal Mutual had an agreement with Southern to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by Donegal Mutual or Atlantic States. This agreement provided for the workers' compensation loss ratio of Southern to be no worse than the average workers' compensation loss ratio of Atlantic States, Southern and Donegal Mutual combined.

Donegal Mutual provides facilities, personnel and other services to us and our insurance subsidiaries. Certain related expenses are allocated between Atlantic States and Donegal Mutual in relation to their relative participation in the pooling agreement. Le Mars, Peninsula and Southern reimburse Donegal Mutual for their personnel costs, and Southern bears its proportionate share of information services costs based on its percentage of total written premiums of the Donegal Insurance Group.

All new agreements and all changes to existing agreements between our insurance subsidiaries and Donegal Mutual are subject to approval by a coordinating committee that is comprised of two of our board members who do not serve on Donegal Mutual board and two members of Donegal Mutual's board who do not serve on our board. In order to approve an agreement or a change in an agreement, our members on the coordinating committee must conclude that the agreement or change is fair and equitable to us and in the best interests of our stockholders, and Donegal Mutual's members on the coordinating committee must conclude that the agreement or change is fair and equitable to Donegal Mutual and in the best interests of its policyholders.

There were no significant changes to the pooling agreement or other reinsurance agreements with Donegal Mutual during 2008 and 2007 except as noted above.

Critical Accounting Policies and Estimates

Our financial statements are combined with those of our insurance subsidiaries and are presented on a consolidated basis in accordance with United States generally accepted accounting principles (GAAP).

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our financial statements. The most significant estimates relate to the reserves of our insurance subsidiaries for property and casualty insurance unpaid losses and loss expenses, valuation of investments and determination of other than temporary impairment and our insurance subsidiaries' policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. The methods for making these estimates are regularly reviewed, and any adjustment considered necessary is reflected in our current results of operations.

Liability for Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. At the time of establishing its estimates, an insurer recognizes that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. Our insurance subsidiaries' estimates of liabilities for losses and loss expenses are based on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and, consequently, it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. We reflect any adjustments to our insurance subsidiaries' liabilities for losses and loss expenses in our operating results in the period in which we make the changes in estimates.

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. Our insurance subsidiaries base the amount of their liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial



interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at December 31, 2008. For every 1% change in our insurance subsidiaries' estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$1.6 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, since the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$2.7 million, (\$10.0) million and (\$13.6) million in 2008, 2007 and 2006, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and there have been no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in those years. The majority of the 2008 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2008 development represented 1.2% of the December 31, 2007 carried reserves and was primarily driven by higher-than-expected severity in the private passenger automobile liability line of business in accident year 2007. Favorable development in 2007 and 2006 related primarily to the private passenger automobile liability, workers' compensation, commercial automobile liability and commercial multi-peril lines of business. Generally, our insurance subsidiaries experienced improving loss development trends during these years attributable to favorable settlements of previously-reported claims by our insurance subsidiaries. Our insurance subsidiaries have implemented advances in automation and added personnel in the past three years to enhance their claims servicing ability. These enhancements have resulted in shorter claim life cycles and more timely settlement of claims, thereby contributing to loss development trends experienced in these periods.

Excluding the impact of isolated catastrophic weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends and economic conditions that have extended the estimated length of disabilities and contributed to increased medical loss costs and a general slowing of settlement rates in litigated claims. Further adjustments to our insurance subsidiaries' estimates could be required in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

Atlantic States' participation in the pool with Donegal Mutual exposes it to adverse loss development on the business of Donegal Mutual that is included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States would proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous and each company has a pro-rata share of the entire pool. Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the intent of the underwriting pool is to produce a more uniform and stable underwriting result from year to year for each company than they would experience individually and to spread the risk of loss between the companies.

Our insurance subsidiaries' liability for losses and loss expenses by major line of business as of December 31, 2008 and 2007 consisted of the following:

(in thousands)	2008	2007
Commercial lines:		
Automobile	\$ 19,758	\$ 20,274
Workers' compensation	36,667	36,309
Commercial multi-peril	27,808	24,847
Other	1,893	1,780
Total commercial lines	86,126	83,210
Personal lines:		
Automobile	60,939	55,796
Homeowners	11,796	10,121
Other	2,445	1,025
Total personal lines	75,180	66,942
Total commercial and personal lines	161,306	150,152
Plus reinsurance recoverable	78,503	76,280
Total liability for losses and loss expenses	\$239,809	\$226,432

We have evaluated the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves. We established the range of reasonably likely changes based on a review of changes in accident year development by line of business and applied it to our insurance subsidiaries' loss reserves as a whole. The selected range does not necessarily indicate what could be the potential best or worst case or likely scenario. The following table sets forth the effect on our insurance subsidiaries' loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves:

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2008	Percentage Change in Equity as of December 31, 2008(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2007	Percentage Change in Equity as of December 31, 2007(1)
			(dollars in thousands)	
-10.0%	\$145,175	2.9%	\$135,137	2.8%
-7.5	149,208	2.2	138,891	2.1
-5.0	153,241	1.4	142,644	1.4
-2.5	157,273	0.7	146,398	0.7
Base	161,306	—	150,152	—
2.5	165,339	-0.7	153,906	-0.7
5.0	169,371	-1.4	157,660	-1.4
7.5	173,404	-2.2	161,413	-2.1
10.0	177,437	-2.9	165,167	-2.8

(1) Net of income tax effect.

Our insurance subsidiaries' reserves for unpaid losses and loss expenses are based on current trends in loss and loss expense development and reflect their best estimates for future amounts needed to pay losses and loss expenses with respect to incurred events currently known to them plus incurred but not reported ("IBNR") claims. Reserve estimates are based on management's assessment of known facts and circumstances, review of historical loss settlement patterns, estimates of trends in claims severity, frequency, legal and regulatory changes and other assumptions. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, have been consistently applied, including consideration of recent case reserve activity. For the year ended December 31, 2008, our insurance subsidiaries used the most-likely number as determined by our actuaries. Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2008, we developed a range from a low of \$147.9 million to a high of \$176.0 million and with a most-likely number of \$161.3 million. The range of estimates for commercial lines in 2008 was \$79.0 million to \$94.0 million (we selected the actuaries' most-likely number of \$86.1 million) and for personal lines in 2008 was \$68.9 million to \$82.1 million (we selected the actuaries' most-likely number of \$75.2 million). Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2007, we developed a range from a low of \$140.2 million to a high of \$160.8 million and with a most-likely number of \$150.2 million. The range of estimates for commercial lines in 2007 was \$77.7 million to \$89.1 million (we selected the actuaries' most-likely number of \$83.3 million) and for personal lines in 2007 was \$62.5 million to \$71.7 million (we selected the actuaries' most-likely number of \$66.9 million).

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. For personal lines products, our insurance subsidiaries insure standard and preferred risks in private passenger automobile and homeowners lines. For commercial lines products, the commercial risks that our insurance subsidiaries primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, limiting industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or professional liability risks. Through the consistent application of this disciplined underwriting philosophy, our insurance subsidiaries have avoided many of the "long-tail" issues faced by other insurance companies. We consider workers' compensation to be a "long-tail" line of business, in that workers' compensation claims tend to be settled over a longer timeframe than those in our other lines of business. The following table presents 2008 and 2007 claim count and payment amount information for workers' compensation. Workers' compensation losses primarily consist of indemnity and medical costs for injured workers. Substantially all of the claims are relatively small individual claims of a similar type.

	For the Year Ended December 31,	
	2008	2007
	(dollars in thousands)	
Number of claims pending, beginning of period	1,452	1,343
Number of claims reported	2,976	3,519
Number of claims settled or dismissed	3,027	3,410
Number of claims pending, end of period	1,401	1,452
Losses paid	\$17,068	\$15,059
Loss expenses paid	3,377	3,035

Investments

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its fair value, and the amount of the write-down is reflected as a realized loss in our results of operations. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including: the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of the security and the occurrence of industry, company and geographic events that have negatively impacted the value of the security or rating agency downgrades. We included losses of \$1.2 million, \$469,000 and \$47,538 in net realized investment (losses) gains in 2008, 2007 and 2006, respectively, for certain equity investments trading below cost on an other than temporary basis.

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2008 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	117,360,120	6,880,692	\$65,626,857	3,331,443
Corporate securities	16,780,992	448,760	2,536,165	733,109

Mortgage-backed securities	2,925,368	24,376	2,928,685	22,526
Equity securities	484,000	59,458	—	—
Totals	\$137,550,480	\$7,413,286	\$71,091,707	\$4,087,078

We have no direct exposure to sub-prime residential mortgage-backed securities and hold no collateralized debt obligations. Substantially all of the unrealized losses in our fixed maturity investment portfolio resulted

from general market conditions and the related impact on our fixed maturity investment valuations. Increases in municipal bond market yields resulted in overall market value declines in our municipal bond holdings as of December 31, 2008. When determining possible impairment of the debt securities we own, we consider unrealized losses that are due to the impact of general market conditions to be temporary in nature because we have the ability and intent to hold the debt securities we own until a recovery of fair value, which may be maturity. We evaluated the near-term prospects of the issuers of those investments in relation to the severity and duration of the impairment. Based upon that evaluation and our ability and intent to hold those investments for a reasonable period of time sufficient for a recovery of fair value, we did not consider those investments to be other than temporarily impaired at December 31, 2008.

We present investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize a pricing service to estimate fair values for our fixed maturity and equity investments. The pricing service utilizes market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing service prepares estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. We review the estimates of fair value provided by the pricing service to determine if the estimates obtained are representative of market prices based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities.

We had no sales or transfers from the held to maturity portfolio in 2008, 2007 or 2006.

Policy Acquisition Costs

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, and amortize them over the period in which our insurance subsidiaries earn the premiums. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the premium is earned.

Management Evaluation of Operating Results

We believe that principal factors contributing to our earnings over the past several years have been the favorable market conditions in the areas in which our insurance subsidiaries operate, their overall premium growth, earnings from acquisitions and our insurance subsidiaries' disciplined underwriting practices.

The property and casualty insurance industry is highly cyclical, and individual lines of business experience their own cycles within the overall insurance industry cycle. Premium rate levels are related to the availability of insurance coverage, which varies according to the level of surplus in the insurance industry and other factors. The level of surplus in the industry varies with returns on capital and regulatory barriers to the withdrawal of surplus. Increases in surplus have generally been accompanied by increased price competition among property and casualty insurers. If our insurance subsidiaries were to find it necessary to reduce premiums or limit premium increases due to competitive pressures on pricing, our insurance subsidiaries could experience a reduction in profit margins and revenues, an increase in ratios of losses and expenses to premiums and, therefore, lower profitability. The cyclicity of the insurance market and its potential impact on our results is difficult to predict with any significant reliability. We evaluate the performance of our commercial lines and personal lines segments primarily based upon underwriting results of our insurance subsidiaries as determined under statutory accounting practices (SAP), which our management uses to measure performance for the total business of our insurance subsidiaries. We use the following financial data to monitor and evaluate our operating results:

(in thousands)	Year Ended December 31,		
	2008	2007	2006
Net premiums written:			
Personal lines:			
Automobile	\$154,091	\$132,452	\$126,211
Homeowners	72,195	58,602	56,005
Other	13,254	11,299	10,764
Total personal lines	239,540	202,353	192,980
Commercial lines:			
Automobile	35,959	32,059	33,387
Workers' compensation	36,459	32,361	32,845
Commercial multi-peril	49,004	43,559	44,750
Other	3,979	3,357	3,445
Total commercial lines	125,401	111,336	114,427
Total net premiums written	\$364,941	\$313,689	\$307,407

Components of GAAP combined ratio:

Loss ratio	64.7%	57.4%	55.8%
Expense ratio	32.1	33.5	32.7
Dividend ratio	0.4	0.4	0.5
GAAP combined ratio	97.2%	91.3%	89.0%

Revenues:

Premiums earned:			
Personal lines	\$225,143	\$196,429	\$185,951
Commercial lines	121,567	113,642	115,527
SAP premiums earned	346,710	310,071	301,478
GAAP adjustments	(135)	—	—
GAAP premiums earned	346,575	310,071	301,478
Net investment income	22,756	22,785	21,320
Realized investment (losses) gains	(2,971)	2,051	1,830
Other	5,952	5,711	5,339

Total revenues	\$372,312	\$340,618	\$329,967
Components of net income:			
Underwriting income (loss):			
Personal lines	\$ (7,609)	\$ 1,736	\$ 9,288
Commercial lines	13,819	22,744	22,495
SAP underwriting income	6,210	24,480	31,783
GAAP adjustments	3,530	2,603	1,270
GAAP underwriting income	9,740	27,083	33,053
Net investment income	22,756	22,785	21,320
Realized investment (losses) gains	(2,971)	2,051	1,830
Other	2,567	930	419
Income before income taxes	32,092	52,849	56,622
Income taxes	(6,550)	(14,569)	(16,407)
Net income	\$ 25,542	\$ 38,280	\$ 40,215

Results of Operations

Years Ended December 31, 2008 and 2007

Net Premiums Written

Our insurance subsidiaries' 2008 net premiums written increased by 16.3% to \$364.9 million, compared to \$313.7 million for 2007. Commercial lines net premiums written increased \$14.1 million, or 12.7%, for 2008 compared to 2007. Personal lines net premiums written increased \$37.1 million, or 18.3%, for 2008 compared to 2007. Net premiums written for 2008 included a \$13.6 million transfer of unearned premiums related to the change in the pooling agreement between Atlantic States and Donegal Mutual effective March 1, 2008 and reflected the impact of the increased pooling allocation of approximately \$24.4 million for the remainder of 2008. Net premiums written during the year also benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007. The lower reinsurance rates were largely due to our decision to increase our per loss retention from \$400,000 to \$600,000 effective January 1, 2008.

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to \$346.6 million for 2008, an increase of \$36.5 million, or 11.8%, over 2007. Our insurance subsidiaries' net earned premiums during 2008 have grown due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of the policies issued by our insurance subsidiaries, which are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier. Net premiums earned in 2008 reflected the impact of an increased pooling allocation and benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007.

Investment Income

For 2008, our net investment income was unchanged from 2007 at \$22.8 million. An increase in our average invested assets from \$598.6 million in 2007 to \$619.0 million in 2008 was offset by a decrease in our annualized average return to 3.7% in 2008 compared to 3.8% in 2007. The decrease in our annualized average rate of return on investments was primarily due to reduced yields on increased holdings of short-term U.S. Treasury investments during 2008. The use of invested assets to redeem \$15.5 million of subordinated debentures in August 2008 also impacted net investment income for 2008.

Installment Payment Fees

Our insurance subsidiaries' installment fees increased primarily as a result of increases in policy counts during 2008.

Net Realized Investment Gains/Losses

Our net realized investment (losses) gains in 2008 and 2007 were (\$3.0) million and \$2.1 million, respectively. Realized investment losses in 2008 included \$2.4 million representing our pro rata share of investment losses in a limited partnership investment that is solely invested in equity securities. Our net realized investment losses in 2008 also included impairment charges of \$1.2 million, compared to impairment charges of \$469,000 recognized in 2007. Our impairment charges for both years were the result of declines in the fair value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from turnover within our investment portfolio.

Losses and Loss Expenses

Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, was 64.7% in 2008, compared to 57.4% in 2007. Our insurance subsidiaries' commercial lines loss ratio increased to 56.6% in 2008, compared to 46.8% in 2007. This increase primarily resulted from the workers' compensation loss ratio increasing to 58.9% in 2008, compared to 44.8% in 2007, and the commercial automobile loss ratio increasing to 53.5% in 2008, compared to 49.1% in 2007, as a result of increased claim severity and less favorable prior-accident-year loss reserve development. The personal lines loss ratio increased to 69.1% in 2008, compared to 63.4% in 2007, primarily as a result of an increase in the personal automobile loss ratio to 73.0% in 2008, compared to 66.0% in 2007, as a result of increased claim severity and less favorable prior-accident-year loss reserve development, and an increase in the homeowners loss ratio to 63.0% in 2008, compared to 61.8% in 2007, as a result of an increase in weather-related claims.

Underwriting Expenses

Our insurance subsidiaries' expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, was 32.1% in 2008, compared to 33.5% in 2007. The decrease in the 2008 expense ratio reflects the benefit of increased net premiums written during the year and decreased underwriting-based incentive compensation costs in 2008 compared to 2007.

Combined Ratio

Our insurance subsidiaries' combined ratio was 97.2% and 91.3% in 2008 and 2007, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned.

Interest Expense

Our interest expense in 2008 was \$1.8 million, compared to \$2.9 million in 2007. The decrease in interest expense reflected the redemption of \$15.5 million of subordinated debentures in August 2008 and a decrease in average interest rates on our subordinated debentures in 2008 compared to 2007.

Income Taxes

Our income tax expense was \$6.6 million in 2008, compared to \$14.6 million in 2007, representing an effective tax rate of 20.4%, compared to 27.6% in 2007. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in 2008 compared to 2007, as we benefited from a 24.6% increase in tax-exempt interest income in 2008 compared to 2007.

Net Income and Earnings Per Share

Our net income in 2008 was \$25.5 million, or \$1.02 per share of Class A common stock and \$.92 per share of Class B common stock on a diluted basis, compared to our net income of \$38.3 million, or \$1.53 per share of Class A common stock and \$1.39 per share of Class B common stock on a diluted basis, in 2007. Our fully diluted Class A shares outstanding in 2008 did not change at 20.0 million. Our Class B shares outstanding did not change at 5.6 million.

Book Value Per Share and Return on Equity

Our stockholders' equity increased by \$10.9 million in 2008, primarily as a result of favorable operating results. Book value per share increased by 2.7% to \$14.29 at December 31, 2008, compared to \$13.92 a year earlier. Our return on average equity was 7.1% in 2008, compared to 11.4% in 2007.

Results of Operations

Years Ended December 31, 2007 and 2006

Net Premiums Written

Our insurance subsidiaries' 2007 net premiums written increased by 2.1% to \$313.7 million, compared to \$307.4 million for 2006. Commercial lines net premiums written decreased \$3.1 million, or 2.7%, for 2007 compared to 2006. Personal lines net premiums written increased \$9.4 million, or 4.9%, for 2007 compared to 2006. Our insurance subsidiaries benefited in 2007 from the addition of the personal lines new business related to increased agent utilization of our WritePro automated underwriting system.

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to \$310.1 million for 2007, an increase of \$8.6 million, or 2.9%, over 2006. Our insurance subsidiaries' net earned premiums during 2007 grew due to the increase in written premiums during the year. Premiums are earned, or recognized as income, over the terms of the policies issued by our insurance subsidiaries, which are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the same period one year earlier.

Investment Income

For 2007, our net investment income increased 7.0% to \$22.8 million, compared to \$21.3 million for 2006. An increase in our average invested assets from \$569.5 million in 2006 to \$598.6 million in 2007 primarily accounted for the increase in investment income in 2007 compared to 2006. Our annualized average return increased to 3.8% compared to 3.7% in 2006. The increase in our annualized average rate of return on investments was primarily due to improved yields generated from the reinvestment of maturity proceeds of lower-yielding bonds, offset in part by decreases in our annualized average rate of return on increased holdings of tax-exempt fixed maturities in our investment portfolio during 2007 compared to 2006.

Installment Payment Fees

Our insurance subsidiaries' installment fees increased primarily as a result of increases in policy counts during 2007.

Net Realized Investment Gains/Losses

Our net realized investment gains in 2007 and 2006 were \$2.1 million and \$1.8 million. Our net realized investment gains in 2007 were net of impairment charges of \$469,000, compared to impairment charges of \$47,538 recognized in 2006. Our impairment charges for both years were the result of declines in the fair value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses

Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, in 2007 was 57.4%, compared to 55.8% in 2006. Our insurance subsidiaries' commercial lines loss ratio decreased to 46.8% in 2007, compared to 48.0% in 2006. This decrease primarily resulted from the workers' compensation loss ratio decreasing to 44.8% in 2007, compared to 53.4% in 2006, and the commercial automobile loss ratio decreasing to 49.1% in 2007, compared to 53.2% in 2006. The personal lines loss ratio increased from 60.7% in 2006 to 63.4% in 2007, primarily as a result of an increase in the personal automobile loss ratio to 66.0% in 2007, compared to 64.2% in 2006, and an increase in the homeowners loss ratio to 61.8% in 2007, compared to 57.4% in 2006, as a result of an increase in weather-related claims. Our insurance subsidiaries' 2007 loss ratios reflected the benefits of decreased claim frequency and favorable prior accident year loss development of \$10.0 million in 2007, compared to favorable prior accident year loss development of \$13.6 million in 2006. Favorable prior accident year loss development in both years was largely due to favorable settlements of open claims.

Underwriting Expenses

Our insurance subsidiaries' expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, was 33.5% in 2007, compared to 32.7% in 2006. The increase in the 2007 expense ratio reflects higher acquisition costs and underwriting-based incentive costs in 2007 compared to 2006.

Combined Ratio

Our insurance subsidiaries' combined ratio was 91.3% and 89.0% in 2007 and 2006, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned.

Interest Expense

Our interest expense in 2007 was \$2.9 million, compared to \$2.8 million in 2006, reflecting increases in the average interest rates on our subordinated debentures during the year compared to 2006.

Income Taxes

Our income tax expense was \$14.6 million in 2007, compared to \$16.4 million in 2006, representing an effective tax rate of 27.6% compared to 29.0% in 2006. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in 2007 compared to 2006, as we benefited from a 16.1% increase in tax-exempt interest income in 2007 compared to 2006.

Net Income and Earnings Per Share

Our net income in 2007 was \$38.3 million, or \$1.53 per share of Class A common stock and \$1.39 per share of Class B common stock on a diluted basis, a decrease of 4.7% from our net income of \$40.2 million, or \$1.60 per share of Class A common stock and \$1.48 per share of Class B common stock on a diluted basis, in 2006. Our fully diluted Class A shares outstanding in 2007 did not change at 20.0 million. Our Class B shares outstanding did not change at 5.6 million.

Book Value Per Share and Return on Equity

Our stockholders' equity increased by \$31.9 million in 2007, primarily as a result of favorable operating results. Book value per share increased by 9.6% to \$13.92 at December 31, 2007, compared to \$12.70 a year earlier. Our return on average equity was 11.4% in 2007, compared to 13.4% in 2006.

Financial Condition

Liquidity and Capital Resources

Liquidity is a measure of an entity's ability to secure enough cash to meet its contractual obligations and operating needs as they arise. Our major sources of funds from operations are the net cash flows generated from our insurance subsidiaries' underwriting results, investment income and maturing investments.

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with Donegal Mutual historically has been cash flow positive

because of the historical profitability of the underwriting pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We maintain a high degree of liquidity in our investment portfolio in the form of marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a “laddering” approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations and the obligations of our insurance subsidiaries should an unexpected variation occur in the future. Net cash flows provided by operating activities in 2008, 2007 and 2006, were \$53.0 million, \$26.7 million and \$33.8 million, respectively.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company (“M&T”) relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2008, we have the ability to borrow \$35.0 million at interest rates equal to M&T’s current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. As of December 31, 2008, we had no borrowings outstanding, and we complied with all requirements of the credit agreement.

The following table shows expected payments for our significant contractual obligations as of December 31, 2008.

(in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses	\$160,091	\$72,941	\$71,219	\$7,335	\$ 8,596
Due to Sheboygan policyholders	6,843	6,843	—	—	—
Subordinated debentures	15,465	—	—	—	15,465
Total contractual obligations	\$182,399	\$79,784	\$71,219	\$7,335	\$24,061

We estimate the timing of the amounts for the net liability for unpaid losses and loss expenses of our insurance subsidiaries based on historical experience and expectations of future payment patterns. The liability has been shown net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Assumed amounts from the underwriting pool with Donegal Mutual represent a substantial portion of our insurance subsidiaries’ gross liability for unpaid losses and loss expenses, and ceded amounts to the underwriting pool represent a substantial portion of our insurance subsidiaries’ reinsurance recoverable on unpaid losses and loss expenses. Future cash settlement of Atlantic States’ assumed liability from the pool will be included in monthly settlements of pooled activity, wherein we net amounts ceded to and assumed from the pool. Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States’ share of the pooled business to 80%, effective March 1, 2008. Although Donegal Mutual and Atlantic States do not anticipate any further changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments for Atlantic States’ proportionate liability for pooled losses occurring in periods prior to the effective date of such change.

We expect to pay amounts due pursuant to Sheboygan’s plan of conversion to Sheboygan policyholders in 2009.

We estimate the timing of the amounts for the subordinated debentures based on their contractual maturities. We may redeem the debentures at our option, at par, after five years from their issuance dates as discussed in Note 10 — Borrowings. Our subordinated debentures carry interest rates that vary based upon the three-month LIBOR rate and adjust quarterly. Based upon the interest rates in effect as of December 31, 2008, our annual interest cost associated with our subordinated debentures is approximately \$1.0 million. For every 1% change in the three-month LIBOR rate, the effect on our annual interest cost would be approximately \$150,000.

Dividends declared to stockholders totaled \$10.4 million, \$8.4 million and \$8.4 million in 2008, 2007 and 2006, respectively. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2008, each of our insurance subsidiaries had capital substantially above the RBC requirements. In 2009, amounts available for distribution as dividends to us without prior approval of their domiciliary insurance regulatory authorities are \$18.4 million from Atlantic States, \$2.8 million from Le Mars, \$3.9 million from Peninsula, \$0 from Sheboygan and \$1.6 million from Southern.

Investments

At December 31, 2008 and 2007, our investment portfolio of primarily investment-grade bonds, common stock, preferred stock, short-term investments and cash totaled \$634.0 million and \$610.2 million, respectively, representing 72.1% and 73.2%, respectively, of our total assets.

At December 31, 2008 and 2007, the carrying value of our fixed maturity investments represented 86.3% and 81.0% of our total invested assets, respectively.

Our fixed maturity investments consisted of high-quality marketable bonds, of which 99.5% and 100% were rated at investment-grade levels at December 31, 2008 and 2007, respectively. As we invested excess cash from operations and proceeds from maturities of fixed maturity investments during 2008, we increased our holdings of tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

At December 31, 2008, the net unrealized gain or loss on available-for-sale fixed maturity investments, net of deferred taxes, amounted to a loss of \$2.1 million, compared to a gain of \$2.9 million at December 31, 2007.

At December 31, 2008, the net unrealized gain on our equity securities, net of deferred taxes, amounted to \$3.7 million, compared to \$4.2 million at December 31, 2007.

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to the impact of interest rate changes, changes in fair values of investments and to credit risk.

In the normal course of business, we employ established policies and procedures to manage our exposure to changes in interest rates, fluctuations in the fair market value of our debt and equity securities and credit risk. We seek to mitigate these risks by various actions described below.

Interest Rate Risk

Our exposure to market risk for a change in interest rates is concentrated in our investment portfolio. We monitor this exposure through periodic reviews of asset and liability positions. We regularly monitor estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio. Generally, we do not hedge our exposure to interest rate risk because we have the capacity to, and do, hold fixed maturity investments to maturity.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2008 are as follows:

(in thousands)	Principal Cash Flows	Weighted-Average Interest Rate
Fixed maturity and short-term investments:		
2009	\$ 86,238	1.34%
2010	22,397	5.43
2011	17,513	5.07
2012	23,615	4.77
2013	18,542	5.07
Thereafter	456,137	4.54
Total	\$624,442	
Fair value	\$624,961	
Debt:		
Thereafter	\$ 15,465	6.91%
Total	\$ 15,465	
Fair value	\$ 15,465	

Actual cash flows from investments may differ from those stated as a result of calls and prepayments.

Equity Price Risk

Our portfolio of equity securities, which we carry on our consolidated balance sheets at estimated fair value, has exposure to price risk, which is the risk of potential loss in estimated fair value resulting from an adverse change in prices. Our objective is to earn competitive relative returns by investing in a diverse portfolio of high-quality, liquid securities.

Credit Risk

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolio of fixed maturity securities and, to a lesser extent, short-term investments is subject to credit risk. We define this risk as the potential loss in fair value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount of our total investment portfolio that we invest in any one security.

Our insurance subsidiaries provide property and liability insurance coverages through independent insurance agencies located throughout their operating areas. The majority of this business is billed directly to the insured, although a portion of our insurance subsidiaries' commercial business is billed through their agents to whom they extend credit in the normal course of business.

Because the pooling agreement does not relieve Atlantic States of primary liability as the originating insurer, Atlantic States is subject to a concentration of credit risk arising from business ceded to Donegal Mutual. Our insurance subsidiaries maintain reinsurance agreements with Donegal Mutual and with a number of other major unaffiliated authorized reinsurers.

Impact of Inflation

Property and casualty insurance premium rates are established before the amount of losses and loss settlement expenses, or the extent to which inflation may impact such expenses, are known. Consequently, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Impact of New Accounting Standards

Effective January 1, 2008, we adopted Financial Accounting Standard (FAS) No. 157, "Fair Value Measurements," which defines fair value, establishes a framework for measuring fair value in GAAP and requires expanded disclosures about fair value measurements. FAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this statement did not have a significant effect on our results of operations, financial condition or liquidity. We included additional disclosures related to FAS No. 157 in Note 6 — Fair Value Measurements. We also adopted Financial Accounting Standards Board (FASB) Staff Position (FSP) No. 157-2, "Effective Date of FASB Statement No. 157," which allowed us to defer the effective date of FAS No. 157 for certain nonfinancial assets and liabilities to January 1, 2009. We do not expect the deferred adoption of FAS No. 157 for nonfinancial assets and liabilities to have a significant effect on our results of operations, financial condition or liquidity.

Effective January 1, 2008, we adopted FAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities — Including an Amendment of FASB Statement No. 115," which permits companies to choose to measure many financial instruments and certain other items at fair value at specified election dates. Upon adoption, an entity reports unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Most of the provisions apply only to entities that elect the fair value option. However, the amendment of FAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," applies to all entities with available-for-sale and trading securities. The adoption of FAS No. 159 had no effect on our results of operations, financial condition or liquidity, as we did not elect the fair value option for any financial instruments.

On October 10, 2008, the FASB issued FSP No. 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." FSP No. 157-3 clarifies the application of FAS No. 157 in a market that is not active. FSP No. 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. Effective September 30, 2008, we adopted the provisions of FSP No. 157-3. The adoption of FSP No. 157-3 had no effect on our results of operations, financial condition or liquidity.

CONSOLIDATED Balance Sheets

December 31,	2008	2007
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value \$101,449,024 and \$155,403,104)	\$ 99,878,156	\$154,290,119
Available for sale, at fair value (amortized cost \$449,009,842 and \$ 331,818,677)	445,815,749	336,317,901
Equity securities, available for sale, at fair value (cost \$2,939,236 and \$ 29,963,843)	5,894,975	36,360,526
Investments in affiliates	8,594,177	8,648,818
Short-term investments, at cost, which approximates fair value	71,952,469	70,252,223
Total investments	632,135,526	605,869,587
Cash	1,830,954	4,289,365
Accrued investment income	6,655,506	5,874,908
Premiums receivable	55,337,270	51,038,253
Reinsurance receivable	79,952,971	78,897,154
Deferred policy acquisition costs	29,541,281	26,235,072
Deferred tax asset, net	10,994,644	7,026,441
Prepaid reinsurance premiums	51,436,487	47,286,336
Property and equipment, net	6,686,684	5,608,129
Accounts receivable – securities	862,790	602,191
Federal income taxes recoverable	2,590,928	—
Other	2,083,995	1,368,320
Total assets	\$880,109,036	\$834,095,756
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	\$239,809,276	\$226,432,402
Unearned premiums	229,013,929	203,430,560
Accrued expenses	14,149,754	12,313,428
Reinsurance balances payable	1,566,816	2,105,501
Federal income taxes payable	—	375,736
Cash dividends declared to stockholders	2,602,104	2,210,298
Subordinated debentures	15,465,000	30,929,000
Accounts payable – securities	1,820,574	1,820,016
Due to affiliate	3,148,057	241,918
Drafts payable	876,210	717,540
Due to Sheboygan policyholders	6,834,454	—
Other	1,229,997	829,166
Total liabilities	516,525,171	481,405,565
Stockholders' Equity		
Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued	—	—
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 20,494,764 and 20,167,999 shares and outstanding 19,869,065 and 19,756,643 shares	204,948	201,680
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	163,136,938	156,850,666
Accumulated other comprehensive income	1,713,836	6,974,411
Retained earnings	207,182,253	193,806,855
Treasury stock, at cost	(8,710,602)	(5,199,913)
Total stockholders' equity	363,583,865	352,690,191
Total liabilities and stockholders' equity	\$880,109,036	\$834,095,756

See accompanying notes to consolidated financial statements.

CONSOLIDATED Statements of Income and Comprehensive Income

Year Ended December 31,	2008	2007	2006
Statements of Income			
Revenues			
Net premiums earned (includes affiliated reinsurance of \$130,607,404, \$107,045,158 and \$106,708,994 – see footnote 3)	\$346,575,266	\$310,071,534	\$301,478,162
Investment income, net of investment expenses	22,755,784	22,785,252	21,320,081
Installment payment fees	5,025,138	4,650,139	4,357,374
Lease income	926,690	1,060,319	981,878
Net realized investment (losses) gains	(2,970,716)	2,051,050	1,829,539
Total revenues	372,312,162	340,618,294	329,967,034
Expenses			
Net losses and loss expenses (includes affiliated reinsurance of \$85,598,098, \$70,676,398 and \$62,753,111 – see footnote 3)	224,300,964	177,783,632	168,421,425
Amortization of deferred policy acquisition costs	58,250,000	51,205,000	48,595,000
Other underwriting expenses	53,108,436	52,726,155	49,970,717
Policy dividends	1,175,809	1,273,323	1,438,494
Interest	1,821,229	2,884,861	2,801,553
Other	1,563,680	1,896,385	2,117,582
Total expenses	340,220,118	287,769,356	273,344,771
Income before income tax expense	32,092,044	52,848,938	56,622,263
Income tax expense	6,550,066	14,569,033	16,407,541
Net income	\$ 25,541,978	\$ 38,279,905	\$ 40,214,722
Earnings per common share:			
Class A common stock	\$ 1.03	\$ 1.55	\$ 1.65
Class B common stock	\$ 0.92	\$ 1.39	\$ 1.48
Diluted earnings per common share:			
Class A common stock	\$ 1.02	\$ 1.53	\$ 1.60
Class B common stock	\$ 0.92	\$ 1.39	\$ 1.48
Statements of Comprehensive Income			
Net income	\$ 25,541,978	\$ 38,279,905	\$ 40,214,722
Other comprehensive (loss) income, net of tax			
Unrealized (losses) gains on securities:			
Unrealized holding (loss) gain arising during the period, net of income (benefit) tax of (\$3,872,368), \$1,748,072 and \$2,002,163	(7,191,540)	3,246,420	3,718,301
Reclassification adjustment for losses (gains) included in net income, net of income (benefit) tax of (\$1,039,751), \$717,867 and \$640,339	1,930,965	(1,333,183)	(1,189,200)
Other comprehensive (loss) income	(5,260,575)	1,913,237	2,529,101
Comprehensive income	\$ 20,281,403	\$ 40,193,142	\$ 42,743,823

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

CONSOLIDATED Statements of Stockholders' Equity

	Common Stock				Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Class A Shares	Class B Shares	Class A Amount	Class B Amount					
Balance, January 1, 2006	19,156,169	5,649,240	\$191,562	\$56,492	\$141,932,954	\$ 2,532,073	\$134,074,853	\$ (891,748)	\$277,896,186
Issuance of common stock (stock compensation plans)	678,079		6,780		6,300,957				6,307,737
Net income							40,214,722		40,214,722
Cash dividends							(8,444,349)		(8,444,349)
Grant of stock options					1,858,525		(1,858,525)		—
Tax benefit on exercise of stock options					2,298,865				2,298,865
Other comprehensive income						2,529,101			2,529,101
Balance, December 31, 2006	19,834,248	5,649,240	\$198,342	\$56,492	\$152,391,301	\$ 5,061,174	\$163,986,701	\$ (891,748)	\$320,802,262
Issuance of common stock (stock compensation plans)	333,751		3,338		3,539,241				3,542,579
Net income							38,279,905		38,279,905
Cash dividends							(8,394,572)		(8,394,572)
Grant of stock options					65,179		(65,179)		—
Tax benefit on exercise of stock options					854,945				854,945
Purchase of treasury stock								(4,308,165)	(4,308,165)
Other comprehensive income						1,913,237			1,913,237
Balance, December 31, 2007	20,167,999	5,649,240	\$201,680	\$56,492	\$156,850,666	\$ 6,974,411	\$193,806,855	\$(5,199,913)	\$352,690,191
Issuance of common stock (stock compensation plans)	326,765		3,268		3,853,328				3,856,596
Net income							25,541,978		25,541,978
Cash dividends							(10,417,517)		(10,417,517)
Grant of stock options					1,749,063		(1,749,063)		—
Tax benefit on exercise of stock options					683,881				683,881
Purchase of treasury stock								(3,510,689)	(3,510,689)
Other comprehensive loss						(5,260,575)			(5,260,575)
Balance, December 31, 2008	20,494,764	5,649,240	\$204,948	\$56,492	\$163,136,938	\$ 1,713,836	\$207,182,253	\$(8,710,602)	\$363,583,865

See accompanying notes to consolidated financial statements.

CONSOLIDATED Statements of Cash Flows

Year Ended December 31,	2008	2007	2006
Cash Flows from Operating Activities:			
Net income	\$ 25,541,978	\$ 38,279,905	\$ 40,214,722
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,401,345	2,446,126	2,714,863
Net realized investment losses (gains)	2,970,716	(2,051,050)	(1,829,539)
Changes in Assets and Liabilities:			
Losses and loss expenses	9,952,760	(32,590,057)	(6,707,068)
Unearned premiums	22,477,395	6,527,588	10,242,922
Accrued expenses	966,958	(440,584)	47,527
Premiums receivable	(3,173,057)	(1,089,799)	(2,824,348)
Deferred policy acquisition costs	(3,306,209)	(1,496,143)	(1,262,336)
Deferred income taxes	(832,628)	1,029,042	1,085,320
Reinsurance receivable	204,249	18,779,861	(3,539,919)
Accrued investment income	(668,682)	(105,821)	(247,752)
Amounts due to/from affiliate	2,906,139	(1,325,173)	838,605
Reinsurance balances payable	(636,074)	70,529	220,680
Prepaid reinsurance premiums	(4,111,609)	(2,909,383)	(4,313,815)
Current income taxes	(2,618,163)	1,374,521	(97,444)
Other, net	898,872	152,805	(791,245)
Net adjustments	27,432,012	(11,627,538)	(6,463,549)
Net cash provided by operating activities	52,973,990	26,652,367	33,751,173
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Available for sale	(204,882,809)	(43,360,830)	(86,959,685)
Purchase of equity securities	(45,091,418)	(29,316,342)	(20,973,078)
Sale of fixed maturities			
Available for sale	28,971,515	—	18,143,309
Maturity of fixed maturities			
Held to maturity	53,830,674	14,222,283	10,281,460
Available for sale	69,699,141	40,206,090	34,133,752
Sale of equity securities	71,177,458	30,160,998	19,406,624
Purchase of Sheboygan (net of cash acquired)	(3,352,938)	—	—
Net decrease (increase) in investment in affiliates	351,935	132,502	(23,343)
Net purchase of property and equipment	(1,222,246)	(1,363,622)	(848,719)
Net purchases of short-term investments	(453,790)	(25,037,964)	(11,014,566)
Net cash used in investing activities	(30,972,478)	(14,356,885)	(37,854,246)
Cash Flows from Financing Activities:			
Issuance of common stock	3,856,596	3,542,579	6,307,737
Redemption of subordinated debentures	(15,464,000)	—	—
Cash dividends paid	(10,025,711)	(8,627,232)	(7,782,784)
Purchase of treasury stock	(3,510,689)	(4,308,165)	—
Tax benefit on exercise of stock options	683,881	854,945	2,298,865
Net cash (used in) provided by financing activities	(24,459,923)	(8,537,873)	823,818
Net (decrease) increase in cash	(2,458,411)	3,757,609	(3,279,255)
Cash at beginning of year	4,289,365	531,756	3,811,011
Cash at end of year	\$ 1,830,954	\$ 4,289,365	\$ 531,756

See accompanying notes to consolidated financial statements.

NOTES TO Consolidated Financial Statements

1 — Summary of Significant Accounting Policies

Organization and Business

Donegal Mutual Insurance Company (“Donegal Mutual”) organized us as an insurance holding company on August 26, 1986. Our insurance subsidiaries, Atlantic States Insurance Company (“Atlantic States”), Southern Insurance Company of Virginia (“Southern”), Le Mars Insurance Company (“Le Mars”), the Peninsula Insurance Group (“Peninsula”), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, and Sheboygan Falls Insurance Company (“Sheboygan”), write personal and commercial lines of property and casualty coverages exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwest and Southern states. We acquired Sheboygan on December 1, 2008, and Sheboygan’s results of operations have been included in our consolidated results from that date. We have three operating segments: the investment function, the personal lines function and the commercial lines function. The personal lines products of our insurance subsidiaries consist primarily of homeowners and private passenger automobile policies. The commercial lines products of our insurance subsidiaries consist primarily of commercial automobile, commercial multi-peril and workers’ compensation policies.

At December 31, 2008, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While maintaining the separate corporate existence of each company, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Atlantic States, our largest subsidiary, participates in a pooling agreement with Donegal Mutual. Under the pooling agreement, the insurance business of the two companies is pooled, and each company receives an allocated percentage of the pooled business. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States’ share of the pooled business to 80%.

The risk profiles of the business Atlantic States and Donegal Mutual write have historically been, and continue to be, substantially similar. The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries.

In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products marketed by our insurance subsidiaries and Donegal Mutual are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group’s ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the underwriting pool, Donegal Mutual and Atlantic States share the underwriting results in proportion to their respective participation in the pool. Pooled business represents the predominant percentage of the net underwriting activity of both Donegal Mutual and Atlantic States. See Note 3 – Transactions with Affiliates for more information regarding the pooling agreement.

We also own 48.2% of the outstanding stock of Donegal Financial Services Corporation (“DFSC”), a thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining 51.8% of the outstanding stock of DFSC.

Basis of Consolidation

Our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, include our accounts and those of our wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The terms “we,” “us,” “our” or the “Company” as used herein refer to the consolidated entity.

Use of Estimates

In preparing our consolidated financial statements, our management makes estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates.

We make estimates and assumptions that can have a significant effect on amounts and disclosures we report in our consolidated financial statements. The most significant estimates relate to our insurance subsidiaries’ reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments and determination of other than temporary impairment and our insurance subsidiaries’ policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the estimates provided. We regularly review the methods for making these estimates, and reflect any adjustment considered necessary in our current results of operations.

Investments

We classify our debt and equity securities into the following categories:

Held to Maturity—Debt securities that we have the positive intent and ability to hold to maturity; reported at amortized cost.

Available for Sale—Debt and equity securities not classified as held to maturity; reported at fair value, with unrealized gains and losses excluded from income and reported as a separate component of stockholders’ equity (net of tax effects).

Short-term investments are carried at amortized cost, which approximates fair value.

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in the value of an individual investment to be other than temporary, we write down the investment to its fair value, and reflect the amount of the write-down as a realized loss in our results of operations. We individually monitor all investments for other than temporary declines in value.

Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we

assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of the security, the occurrence of industry, company and geographic events that have negatively impacted the value of the security or rating agency downgrades.

We amortize premiums and discounts on debt securities over the life of the security as an adjustment to yield using the effective interest method. We compute realized investment gains and losses using the specific identification method.

We amortize premiums and discounts for mortgage-backed debt securities using anticipated prepayments.

We account for investments in affiliates for using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock." Under the equity method, we record our investment at cost, with adjustments for our share of affiliate earnings and losses as well as changes in affiliate equity due to unrealized gains and losses.

Fair Values of Financial Instruments

We have used the following methods and assumptions in estimating our fair value disclosures:

Investments—We present investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize a pricing service to estimate fair values for our fixed maturity and equity investments. The pricing service utilizes market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing service prepares estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. We review the estimates of fair value provided by the pricing service to determine if the estimates obtained are representative of market prices based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities.

Cash and Short-Term Investments—The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Premium and Reinsurance Receivables and Payables—The carrying amounts reported in the balance sheet for these instruments approximate their fair values.

Subordinated Debentures—The carrying amounts reported in the balance sheet for these instruments approximate their fair values due to their variable rate nature.

Revenue Recognition

Our insurance subsidiaries recognize insurance premiums as income over the terms of the policies. Our insurance subsidiaries calculate unearned premiums on a daily pro-rata basis.

Policy Acquisition Costs

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, and amortize them over the period in which our insurance subsidiaries earn the premiums. The method we follow in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs we expect to incur as our insurance subsidiaries earn the premium. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to changes in key assumptions.

Property and Equipment

We report property and equipment at depreciated cost that is computed using the straight-line method based upon estimated useful lives of the assets.

Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. An insurer recognizes at the time of establishing its estimates that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. We base our insurance subsidiaries' estimates of liabilities for losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and consequently it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. Our insurance subsidiaries reflect any adjustments to their liabilities for losses and loss expenses in their operating results in the period in which the changes in estimates are made.

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. Our insurance subsidiaries base the amount of liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. Our insurance subsidiaries determine the amount of their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends, and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced a decrease in claims

during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and closure rates and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded.

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. Our insurance subsidiaries' personal lines products include standard and preferred risks in private passenger automobile and homeowners lines. Our insurance subsidiaries commercial lines products primarily include mercantile risks, business offices, wholesalers, service providers and artisan risks, avoiding industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or other professional liability risks.

Income Taxes

We currently file a consolidated federal income tax return.

We account for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at enacted tax rates expected to be in effect when we realize or settle such amounts.

Credit Risk

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. Our portfolio of fixed maturity securities and, to a lesser extent, short-term investments is subject to credit risk. We define this risk as the potential loss in fair value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the amount of our total investment portfolio that we invest in any one security.

Our insurance subsidiaries provide property and liability coverages through independent agency systems located throughout their operating areas. Our insurance subsidiaries bill the majority of this business directly to the insured, although they bill a portion of their commercial business through their agents, to whom they extend credit in the normal course of business.

Our insurance subsidiaries have reinsurance agreements with Donegal Mutual and with a number of other authorized reinsurers with at least an A.M. Best rating of A- or an equivalent financial condition.

Reinsurance Accounting and Reporting

Our insurance subsidiaries rely upon reinsurance agreements to limit their maximum net loss from large single risks or risks in concentrated areas, and to increase their capacity to write insurance. Reinsurance does not relieve the primary insurer from liability to its policyholders. To the extent that a reinsurer cannot pay losses for which it is liable under the terms of a reinsurance agreement, our insurance subsidiaries have the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, our insurance subsidiaries require all of their reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition that, in the opinion of management, is equivalent to a company with at least an A-rating. All reinsurance transactions are recorded in a manner consistent with Financial Accounting Standards Board (FASB) Financial Accounting Standard (FAS) 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts." See Note 11 – Reinsurance for more information regarding our reinsurance agreements.

Stock-Based Compensation

Effective January 1, 2006, we adopted FAS No. 123(R), "Share-Based Payment," superseding APB Opinion No. 25. FAS No. 123(R) requires the measurement of all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our results of operations.

FAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions Involving Stock Compensation," and Emerging Issues Task Force Issue No. 00-23 (EITF 00-23), "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions Involving Stock Compensation." Pursuant to FIN No. 44, APB Opinion No. 25 did not apply to the separate financial statements of a subsidiary in accounting for share-based compensation granted by the subsidiary to employees of the parent or another subsidiary. EITF 00-23 states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to us, because Donegal Mutual is the employer of record for the majority of the employees that provide services to us.

FAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous rules. We classified tax benefits realized upon the exercise of stock options of \$683,881, \$854,945 and \$2.3 million for the years ended December 31, 2008, 2007 and 2006, respectively, as financing activities in our consolidated statements of cash flows.

Earnings per Share

We calculate basic earnings per share by dividing net income by the weighted-average number of common shares outstanding for the period, while diluted earnings per share reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than those declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share pursuant to FAS No. 128, "Earnings Per Share." The two-class method is an earnings

allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class.

2 — Impact of New Accounting Standards

Effective January 1, 2008, we adopted FAS No. 157, “Fair Value Measurements,” which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP) and requires expanded disclosures about fair value measurements. FAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this statement did not have a significant effect on our results of operations, financial condition or liquidity. We included additional disclosures related to FAS No. 157 in Note 6 – Fair Value Measurements. We also adopted FASB Staff Position (FSP) No. 157-2, “Effective Date of FASB Statement No. 157,” which allowed us to defer the effective date of FAS No. 157 for certain nonfinancial assets and liabilities to January 1, 2009. We do not expect the deferred adoption of FAS No. 157 for nonfinancial assets and liabilities to have a significant effect on our results of operations, financial condition or liquidity.

Effective January 1, 2008, we adopted FAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115,” which permits companies to choose to measure many financial instruments and certain other items at fair value at specified election dates. Upon adoption, an entity reports unrealized gains and losses on items for which the entity has selected the fair value option in earnings at each subsequent reporting date. Most of the provisions apply only to entities that elect the fair value option. However, the amendment of FAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities,” applies to all entities with available-for-sale and trading securities. Effective January 1, 2008, we adopted FAS No. 159. The adoption of FAS No. 159 had no effect on our results of operations, financial condition or liquidity.

On October 10, 2008, the FASB issued FSP No. 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.” FSP No. 157-3 clarifies the application of FAS No. 157 in a market that is not active. FSP No. 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. Effective September 30, 2008, we adopted the provisions of FSP No. 157-3. The adoption of FSP No. 157-3 had no effect on our results of operations, financial condition or liquidity.

3 — Transactions with Affiliates

Our insurance subsidiaries conduct business and have various agreements with Donegal Mutual that are described below:

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies contribute all of their direct written business to the pool and receive an allocated percentage of their combined underwriting results, excluding certain reinsurance Donegal Mutual assumes from our insurance subsidiaries. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States’s share of the pooled business to 80%. The intent of the pooling agreement is to produce more uniform and stable underwriting results from year to year for each pool participant than they would experience individually and to spread the risk of loss between the participants based on each participant’s relative amount of surplus and relative access to capital. Each participant in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposures of a size commensurate with its own capital and surplus.

The following amounts represent reinsurance Atlantic States ceded to the pooling agreement during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$93,336,444	\$86,026,309	\$76,945,746
Losses and loss expenses	\$54,407,168	\$42,017,980	\$37,552,309
Prepaid reinsurance premiums	\$48,448,624	\$45,275,947	\$42,311,034
Liability for losses and loss expenses	\$45,777,168	\$46,226,796	\$50,769,807

The following amounts represent reinsurance Atlantic States assumed from the pooling agreement during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$220,641,805	\$193,690,192	\$187,590,899
Losses and loss expenses	\$140,969,892	\$109,118,227	\$100,804,383
Unearned premiums	\$110,064,380	\$ 95,691,236	\$ 95,121,169
Liability for losses and loss expenses	\$121,366,321	\$113,458,587	\$122,491,281

Donegal Mutual and Southern have a quota-share reinsurance agreement whereby Southern assumes 100% of the premiums and losses related to personal lines products Donegal Mutual offers in Virginia through the use of its automated policy quoting and issuance system. The following amounts represent reinsurance Southern assumed from Donegal Mutual pursuant to the quota-share reinsurance agreement during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$9,690,726	\$5,378,608	\$1,522,593
Losses and loss expenses	\$7,612,090	\$3,797,947	\$ 621,216
Unearned premiums	\$6,064,734	\$4,101,974	\$1,770,965
Liability for losses and loss expenses	\$2,672,698	\$1,152,041	\$ 113,838

Donegal Mutual and Peninsula have a quota-share reinsurance agreement whereby Donegal Mutual assumes 100% of the premiums and losses related to the workers’ compensation product line of Peninsula Indemnity Company. Prior to January 1, 2002, Donegal Mutual and Southern had a quota share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to Donegal Mutual. The business assumed by Donegal Mutual becomes part of the

pooling agreement between Donegal Mutual and Atlantic States. The following amounts represent reinsurance ceded to Donegal Mutual pursuant to the quota-share reinsurance agreements during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$880,017	\$ 457,074	\$ 44,815
Losses and loss expenses	\$697,929	\$(165,655)	\$ (162,935)
Prepaid reinsurance premiums	\$889,993	\$ 60,961	\$ 233,327
Liability for losses and loss expenses	\$679,718	\$ 836,031	\$1,213,874

Atlantic States, Southern and Le Mars each have a catastrophe reinsurance agreement with Donegal Mutual that limits the maximum liability under any one catastrophic occurrence to \$800,000, \$600,000 and \$500,000, respectively, with a combined limit of \$1,500,000 for a catastrophe involving a combination of these subsidiaries. Donegal Mutual and Southern have an excess of loss reinsurance agreement in which Donegal Mutual assumes up to \$300,000 (\$150,000 in 2007 and 2006) of losses in excess of \$300,000 (\$250,000 in 2007 and 2006). Through December 31, 2006, Donegal Mutual had an agreement with Southern to reallocate the loss results of workers' compensation business written by Southern as part of commercial accounts primarily written by Donegal Mutual or Atlantic States. This agreement provided for the workers' compensation loss ratio of Southern to be no worse than the average workers' compensation loss ratio of Atlantic States, Southern and Donegal Mutual combined. The following amounts represent reinsurance ceded to Donegal Mutual pursuant to these reinsurance agreements during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$5,508,666	\$5,540,259	\$5,413,937
Losses and loss expenses	\$7,878,787	\$ 387,451	\$1,283,114
Liability for losses and loss expenses	\$5,456,611	\$3,171,245	\$4,083,733

The following amounts represent the effect of affiliated reinsurance transactions on net premiums our insurance subsidiaries earned during 2008, 2007 and 2006:

	2008	2007	2006
Assumed	\$230,332,531	\$199,068,800	\$189,113,492
Ceded	(99,725,127)	(92,023,642)	(82,404,498)
Net	\$130,607,404	\$107,045,158	\$106,708,994

The following amounts represent the effect of affiliated reinsurance transactions on net losses and loss expenses our insurance subsidiaries incurred during 2008, 2007 and 2006:

	2008	2007	2006
Assumed	\$148,581,982	\$112,916,174	\$101,425,599
Ceded	(62,983,884)	(42,239,776)	(38,672,488)
Net	\$ 85,598,098	\$ 70,676,398	\$ 62,753,111

b. Expense Sharing

Donegal Mutual provides facilities, management and other services to us and our insurance subsidiaries, and we and our insurance subsidiaries reimburse Donegal Mutual for such services on a periodic basis under usage and pooling agreements. We allocate charges primarily upon the relative participation of Atlantic States and Donegal Mutual in the pooling agreement, and our management and the management of Donegal Mutual consider this allocation to be reasonable. Charges for these services totalled \$56,819,869, \$52,268,253 and \$48,828,587 for 2008, 2007 and 2006, respectively.

c. Lease Agreement

We lease office equipment and automobiles with terms ranging from 3 to 10 years to Donegal Mutual under a 10-year lease agreement dated January 1, 2000.

d. Legal Services

Donald H. Nikolaus, our President and one of our directors, is a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as our general counsel since 1986, principally in connection with the defense of claims litigation arising in Lancaster, Dauphin and York counties of Pennsylvania. We pay such firm its customary fees for such services.

e. Province Bank

As of December 31, 2008 and 2007, we had \$2,063,569 and \$3,899,214, respectively, in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. We earned \$133,251, \$210,654 and \$179,674 in interest on these accounts during 2008, 2007 and 2006, respectively.

4 — Business Combinations

During 2008, we acquired all of the outstanding stock of Sheboygan. We accounted for this acquisition for as a business combination in accordance with FAS No. 141, "Business Combinations."

In December 2006, Donegal Mutual consummated an affiliation with Sheboygan. As part of the affiliation, Donegal Mutual entered into a management agreement with and made a \$3.5 million contribution note investment in Sheboygan. During 2007, Sheboygan's board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired all of the outstanding stock of Sheboygan as of December 1, 2008 for approximately \$12.0 million in cash, including payment of the principal amount of the contribution note (\$3.5 million) and accrued interest (\$32,171) to Donegal Mutual. The payment also included a surplus contribution (\$8.5 million) to Sheboygan to support future premium growth. The operating results of Sheboygan for the month of December 2008 have been included in our consolidated financial statements. Amounts due to policyholders pursuant to the plan of conversion were \$6.8 million at December 31, 2008. We anticipate paying these amounts to Sheboygan policyholders in 2009.

The acquisition of Sheboygan enables us to conduct our insurance business in Wisconsin. Sheboygan, organized under the laws of Wisconsin in 1899, operates as a property and casualty insurer in Wisconsin. Personal lines coverages represent a majority of Sheboygan's premiums written, with the balance coming from farmowners and mercantile and service businesses. Sheboygan's largest lines of business are homeowners, private passenger automobile liability and physical damage. For the years ended December 31, 2008 and 2007, Sheboygan had statutory net premiums earned of \$7.9 million and \$7.7 million, respectively. For the years ended December 31, 2008 and 2007, Sheboygan had a statutory net (loss) income of (\$1.1) million and \$632,202, respectively. Sheboygan's total admitted assets on a statutory basis as of December 31, 2008 and 2007 were \$25.7 million and \$17.5 million, respectively. Sheboygan's surplus on a statutory basis as of December 31, 2008 and 2007 was \$11.2 million and \$10.6 million, respectively. All statutory amounts for 2008 and 2007 are unaudited. We based the purchase price of Sheboygan upon an independent valuation of Sheboygan as of September 30, 2008.

5 — Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2008 and 2007 are as follows:

	2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 8,516,714	\$ 176,071	\$ —	\$ 8,692,785
Obligations of states and political subdivisions	76,450,762	1,954,867	231,545	78,174,084
Corporate securities	8,341,519	57,124	391,701	8,006,942
Mortgage-backed securities	6,569,161	35,256	29,204	6,575,213
Totals	\$99,878,156	\$2,223,318	\$652,450	\$101,449,024

	2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 6,525,568	\$ 104,732	\$ —	\$ 6,630,300
Obligations of states and political subdivisions	341,662,882	5,320,541	9,980,590	337,002,833
Corporate securities	24,517,546	208,337	790,169	23,935,714
Mortgage-backed securities	76,303,846	1,960,753	17,697	78,246,902
Fixed maturities	449,009,842	7,594,363	10,788,456	445,815,749
Equity securities	2,939,236	3,015,197	59,458	5,894,975
Totals	\$451,949,078	\$10,609,560	\$10,847,914	\$451,710,724

	2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 51,611,229	\$ 47,345	\$180,601	\$ 51,477,973
Obligations of states and political subdivisions	81,456,831	1,410,751	51,388	82,816,194
Corporate securities	9,838,116	184,178	157,005	9,865,289
Mortgage-backed securities	11,383,943	11,760	152,055	11,243,648
Totals	\$154,290,119	\$1,654,034	\$541,049	\$155,403,104

	2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 25,006,283	\$ 368,384	\$ 738	\$ 25,373,929
Obligations of states and political subdivisions	247,872,566	4,137,675	144,261	251,865,980
Corporate securities	15,237,336	178,858	187,979	15,228,215
Mortgage-backed securities	43,702,492	262,725	115,440	43,849,777
Fixed maturities	331,818,677	4,947,642	448,418	336,317,901
Equity securities	29,963,843	8,607,021	2,210,338	36,360,526
Totals	\$361,782,520	\$13,554,663	\$2,658,756	\$372,678,427

The amortized cost and estimated fair value of fixed maturities at December 31, 2008, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Held to maturity		
Due in one year or less	\$ 8,616,994	\$ 8,701,167
Due after one year through five years	9,497,703	9,269,178
Due after five years through ten years	70,026,031	71,858,911
Due after ten years	5,168,267	5,044,555
Mortgage-backed securities	6,569,161	6,575,213
Total held to maturity	\$ 99,878,156	\$101,449,024
Available for sale		
Due in one year or less	\$ 5,446,860	\$ 5,391,063
Due after one year through five years	68,208,362	68,853,701
Due after five years through ten years	100,913,342	104,103,603
Due after ten years	198,137,432	189,220,480
Mortgage-backed securities	76,303,846	78,246,902
Total available for sale	\$449,009,842	\$445,815,749

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2008 and 2007 amounted to \$9,189,695 and \$8,937,345, respectively. Investments in affiliates consisted of the following at December 31, 2008 and 2007:

	2008	2007
DFSC	\$8,129,177	\$7,719,818
Other	465,000	929,000
Total	\$8,594,177	\$8,648,818

We made additional equity investments in DFSC in the amounts of \$0 and \$50,000 during 2008 and 2007, respectively. Other expenses in our consolidated statements of income include income (expenses) of \$112,065, (\$182,502) and (\$176,657) for 2008, 2007 and 2006, respectively, representing our share of DFSC's income or loss. In addition, other comprehensive income (loss) in our statements of comprehensive income includes net unrealized gains (losses) of \$193,241, \$206,871 and

(\$1,189) for 2008, 2007 and 2006, respectively, representing our share of DFSC's unrealized investment gains or losses.

Other investment in affiliates represents our investment in statutory trusts that hold our subordinated debentures as discussed in Note 10.

We derive net investment income, consisting primarily of interest and dividends, from the following sources:

	2008	2007	2006
Fixed maturities	\$23,379,999	\$21,670,399	\$20,557,402
Equity securities	552,575	853,960	992,139
Short-term investments	1,079,325	2,146,342	1,805,082
Other	36,008	34,214	34,180
Investment income	25,047,907	24,704,915	23,388,803
Investment expenses	(2,292,123)	(1,919,663)	(2,068,722)
Net investment income	\$22,755,784	\$22,785,252	\$21,320,081

Gross realized gains and losses from investments and the change in the difference between fair value and cost of investments, before applicable income taxes, are as follows:

	2008	2007	2006
Gross realized gains:			
Fixed maturities	\$ 1,641,249	\$ 246,959	\$ 128,395
Equity securities	2,397,716	2,830,592	2,482,396
	4,038,965	3,077,551	2,610,791
Gross realized losses:			
Fixed maturities	311,900	11,286	492,968
Equity securities	6,697,781	1,015,215	288,284
	7,009,681	1,026,501	781,252
Net realized (losses) gains	\$ (2,970,716)	\$2,051,050	\$1,829,539
Change in difference between fair value and cost of investments:			
Fixed maturities	\$ (7,235,434)	\$5,132,415	\$2,060,966
Equity securities	(3,440,944)	(639,612)	2,658,296
Totals	\$(10,676,378)	\$4,492,803	\$4,719,262

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2008 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	117,360,120	6,880,692	\$65,626,857	3,331,443
Corporate securities	16,780,992	448,760	2,536,165	733,109
Mortgage-backed securities	2,925,368	24,376	2,928,685	22,526
Equity securities	484,000	59,458	—	—
Totals	\$137,550,480	\$7,413,286	\$71,091,707	\$4,087,078

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2007 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ —	\$ —	\$41,578,756	\$ 181,339
Obligations of states and political subdivisions	19,731,538	94,664	15,400,005	100,985
Corporate securities	2,326,115	179,353	7,625,643	165,629
Mortgage-backed securities	—	—	23,924,233	267,496
Equity securities	8,457,522	1,340,344	2,193,020	869,995
Totals	\$30,515,175	\$1,614,361	\$90,721,657	\$1,585,444

We have no direct exposure to sub-prime residential mortgage-backed securities and hold no collateralized debt obligations. Substantially all of the unrealized losses in our fixed maturity investment portfolio resulted from general market conditions and the related impact on our fixed maturity investment valuations. Increases in municipal bond market yields resulted in overall market value declines in our municipal bond holdings as of December 31, 2008. When determining possible impairment of the debt securities we own, we consider unrealized losses that are due to the impact of general market conditions to be temporary in nature because we have the ability and intent to hold the debt securities we own until a recovery of fair value, which may be maturity. We evaluated the near-term prospects of the issuers of those investments in relation to the severity and duration of the impairment. Based upon that evaluation and our ability and intent to hold those investments for a reasonable period of time sufficient for a recovery of fair value, we did not consider those investments to be other than temporarily impaired at December 31, 2008. The estimated fair value of a security may differ from the amount that could be realized if the security was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur.

We included losses of \$1.2 million, \$469,000 and \$47,538 in net realized investment (losses) gains in 2008, 2007 and 2006, respectively, for certain equity investments trading below cost on an other than temporary basis.

We had no sales or transfers from the held to maturity portfolio in 2008, 2007 or 2006.

We have no derivative instruments or hedging activities.

6 — Fair Value Measurements

As of January 1, 2008, we adopted FAS No. 157, “Fair Value

Measurements,” which defines fair value, establishes a framework for measuring fair value in GAAP and requires expanded disclosures about fair value measurements. FAS No. 157 establishes a hierarchy that ranks the quality and reliability of inputs, or assumptions, used in the determination of fair value and requires financial assets and liabilities carried at fair value to be classified and disclosed in one of the following three categories:

Level 1 — quoted prices in active markets for identical assets and liabilities;

Level 2 — directly or indirectly observable inputs other than Level 1 quoted prices; and

Level 3 — unobservable inputs not corroborated by market data.

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly traded equity securities as Level 1. When quoted market prices in active markets are not available, we base fair values on quoted market prices of comparable instruments or broker quotes we obtain from independent pricing services through a bank trustee. We classify our fixed maturity securities as Level 2. We had no investments classified as Level 3 at December 31, 2008.

We evaluate assets and liabilities on a recurring basis to determine the appropriate level at which to classify them for each reporting period. The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of December 31, 2008:

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(dollars in thousands)		
Fixed maturities – available for sale	\$445,815,749	\$ —	\$445,815,749	\$—
Equity securities	5,895,975	4,971,501	924,474	—
Total	\$451,711,724	\$4,971,501	\$446,740,223	\$—

7 — Deferred Policy Acquisition Costs

Changes in our insurance subsidiaries' deferred policy acquisition costs are as follows:

	2008	2007	2006
Balance, January 1	\$ 26,235,072	\$ 24,738,929	\$ 23,476,593
Acquisition costs deferred	61,556,209	52,701,143	49,857,336
Amortization charged to earnings	(58,250,000)	(51,205,000)	(48,595,000)
Balance, December 31	\$ 29,541,281	\$ 26,235,072	\$ 24,738,929

8 — Property and Equipment

Property and equipment at December 31, 2008 and 2007 consisted of the following:

	2008	2007	Estimated Useful Life
Office equipment	\$ 7,835,404	\$ 7,244,414	5-15 years
Automobiles	1,576,055	1,693,887	3 years
Real estate	4,981,529	3,908,506	15-50 years
Software	1,077,790	855,316	5 years
	15,470,778	13,702,123	
Accumulated depreciation	(8,784,094)	(8,093,994)	
	\$ 6,686,684	\$ 5,608,129	

Depreciation expense for 2008, 2007 and 2006 amounted to \$1.0 million, \$901,798 and \$936,837, respectively.

9 — Liability for Losses and Loss Expenses

The establishment of an appropriate liability for losses and loss expenses is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed their loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, since the historical conditions and events that serve as a basis for their estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods our insurance subsidiaries' estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received since the prior reporting date.

We summarize activity in our insurance subsidiaries' liability for losses and loss expenses as follows:

	2008	2007	2006
Balance at January 1	\$226,432,402	\$259,022,459	\$265,729,527
Less reinsurance recoverable	(76,280,437)	(95,710,496)	(92,720,643)
Net balance at January 1	150,151,965	163,311,963	173,008,884
Acquisition of Sheboygan	2,173,374	—	—
Incurred related to:			
Current year	221,617,127	187,796,474	182,037,189
Prior years	2,683,837	(10,012,842)	(13,615,764)
Total incurred	224,300,964	177,783,632	168,421,425
Paid related to:			
Current year	143,369,098	118,444,254	106,400,754
Prior years	71,950,447	72,499,376	71,717,592
Total paid	215,319,545	190,943,630	178,118,346
Net balance at December 31	161,306,758	150,151,965	163,311,963

Plus reinsurance recoverable	78,502,518	76,280,437	95,710,496
Balance at December 31	\$239,809,276	\$226,432,402	\$259,022,459

Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$2.7 million, (\$10.0) million and (\$13.6) million in 2008, 2007 and 2006, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and have made no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in these years. The majority of the 2008 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2008 development represented 1.2% of the December 31, 2007 carried reserves and was primarily driven by higher-than-expected severity in the private passenger automobile liability line of business in accident year 2007. Our insurance subsidiaries recognized favorable development in 2007 and 2006 primarily in the private passenger automobile liability, workers' compensation, commercial automobile liability and commercial multi-peril lines of business. Generally, our insurance subsidiaries experienced improving loss development trends during these years, which they attribute to favorable settlements of previously-reported claims. Our insurance subsidiaries have implemented advances in automation and added personnel in the past three years to enhance their claims servicing ability. These enhancements have resulted in shorter claim life cycles and more timely settlement of claims, thereby contributing to loss development trends experienced in these periods.

10 — Borrowings

Line of Credit

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company (“M&T”) relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2008, we may borrow up to \$35.0 million at interest rates equal to M&T’s current prime rate or the then current London Interbank Eurodollar bank rate (LIBOR) plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the year ended December 31, 2008, we had no outstanding borrowings, and we complied with all requirements of the credit agreement.

Subordinated Debentures

On May 15, 2003, we received \$15.0 million in net proceeds from the issuance of subordinated debentures. We redeemed these debentures on August 15, 2008. As of December 31, 2007, our consolidated balance sheet included an investment in a statutory trust of \$464,000 and subordinated debentures of \$15.5 million related to this transaction.

On October 29, 2003, we received \$10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2008, the interest rate on these debentures was 7.36%, and was next subject to adjustment on January 29, 2009. As of December 31, 2008 and 2007, our consolidated balance sheets included an investment in a statutory trust of \$310,000 and subordinated debentures of \$10.3 million related to this transaction.

On May 24, 2004, we received \$5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after May 24, 2009. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2008, the interest rate on these debentures was 6.00%, and was next subject to adjustment on February 24, 2009. As of December 31, 2008 and 2007, our consolidated balance sheets included an investment in a statutory trust of \$155,000 and subordinated debentures of \$5.2 million related to this transaction.

11 — Reinsurance

Unaffiliated Reinsurers

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars, Peninsula and Sheboygan have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with their requirements, have an A.M. Best rating of A-(Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The external reinsurance Atlantic States, Southern and Donegal Mutual purchase includes “excess of loss reinsurance,” under which their losses are automatically reinsured, through a series of contracts, over a set retention (\$600,000), and “catastrophic reinsurance,” under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million). Our insurance subsidiaries’ principal third party reinsurance agreement in 2008 was a multi-line per risk excess of loss treaty that provided 100% coverage up to \$1.0 million for both property and liability losses over the set retention. For property insurance, our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multiline treaty up to \$2.5 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$40.0 million per occurrence. For workers’ compensation insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$10.0 million on any one life. Atlantic States, Southern and Donegal Mutual had property catastrophe coverage through a series of layered treaties up to aggregate losses of \$100.0 million for any single event. As many as 10 reinsurers provided coverage on any one treaty with no reinsurer taking more than 22.0% of any one contract. The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risks being reinsured. Donegal Mutual and our insurance subsidiaries also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance. The following amounts represent reinsurance our insurance subsidiaries ceded to unaffiliated reinsurers during 2008, 2007 and 2006:

	2008	2007	2006
Premiums written	\$19,458,572	\$22,922,229	\$21,820,998
Premiums earned	\$19,348,674	\$22,805,393	\$21,719,407
Losses and loss expenses	\$11,129,036	\$ 4,934,928	\$20,158,275
Prepaid reinsurance premiums	\$ 2,097,870	\$ 1,949,428	\$ 1,832,592
Liability for losses and loss expenses	\$27,258,815	\$26,046,365	\$39,643,082

Total Reinsurance

The following amounts represent reinsurance our insurance subsidiaries ceded to both affiliated and unaffiliated reinsurers during 2008, 2007 and 2006:

	2008	2007	2006
Premiums earned	\$119,073,801	\$114,829,037	\$104,123,905
Losses and loss expenses	\$ 74,112,920	\$ 47,174,704	\$ 58,830,763
Prepaid reinsurance premiums	\$ 51,436,487	\$ 47,286,334	\$ 44,376,953
Liability for losses and loss expenses	\$ 79,172,312	\$ 76,280,437	\$ 95,710,496

The following amounts represent the effect of reinsurance on premiums written for 2008, 2007 and 2006:

	2008	2007	2006
--	------	------	------

Direct	\$ 241,371,353	\$ 229,328,954	\$ 220,192,787
Assumed	246,755,110	202,099,203	195,652,202
Ceded	(123,185,408)	(117,738,418)	(108,437,720)
Net premiums written	\$ 364,941,055	\$ 313,689,739	\$ 307,407,269

The following amounts represent the effect of reinsurance on premiums earned for 2008, 2007 and 2006:

	2008	2007	2006
Direct	\$ 235,212,229	\$ 225,684,220	\$ 216,319,824
Assumed	230,436,838	199,216,351	189,282,243
Ceded	(119,073,801)	(114,829,037)	(104,123,905)
Net premiums earned	\$ 346,575,266	\$ 310,071,534	\$ 301,478,162

12 — Income Taxes

Our provision for income tax consists of the following:

	2008	2007	2006
Current	\$7,382,694	\$13,539,991	\$15,322,221
Deferred	(832,628)	1,029,042	1,085,320
Federal tax provision	\$6,550,066	\$14,569,033	\$16,407,541

Our effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2008, 2007 and 2006. The reasons for such difference and the related tax effects are as follows:

	2008	2007	2006
Income before income taxes	\$32,092,044	\$52,848,938	\$56,622,263
Computed "expected" taxes	11,232,215	18,497,128	19,817,792
Tax-exempt interest	(5,668,566)	(4,548,711)	(3,929,188)
Dividends received deduction	(62,470)	(125,977)	(118,060)
Other, net	1,048,887	746,593	636,997
Federal income tax provision	\$ 6,550,066	\$14,569,033	\$16,407,541

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2008 and 2007 are as follows:

	2008	2007
Deferred tax assets:		
Unearned premium	\$12,506,590	\$10,942,790
Loss reserves	5,309,536	5,166,515
Net operating loss carryforward - acquired companies	2,628,568	3,069,379
Other	3,510,896	1,917,331
Total gross deferred assets	23,955,590	21,096,015
Less valuation allowance	(746,368)	(770,799)
Net deferred tax assets	23,209,222	20,325,216
Deferred tax liabilities:		
Depreciation expense	570,539	147,844
Deferred policy acquisition costs	10,531,684	9,182,275
Salvage recoverable	189,521	213,203
Net unrealized gains	922,834	3,755,453
Total gross deferred liabilities	12,214,578	13,298,775
Net deferred tax asset	\$10,994,644	\$ 7,026,441

We provide a valuation allowance when we believe it is more likely than not that we will not realize some portion of the tax asset. Our management established a valuation allowance of \$746,368 related to a portion of the net operating loss carryforward of Le Mars at January 1, 2004. Management has determined that it is not required to establish a valuation allowance for the other net deferred tax assets of \$23,209,222 and \$20,325,216 at December 31, 2008 and 2007, respectively, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carrybacks to taxable income in prior years and the implementation of tax planning strategies.

At December 31, 2008, we have a net operating loss carryforward of \$7.5 million, which is available to offset our taxable income. This amount will begin to expire in 2011 if not utilized and is subject to an annual limitation in the amount that we can use in any one year of approximately \$376,000. We also have an alternative minimum tax credit carryforward of \$412,374 with an indefinite life.

13 — Stockholders' Equity

On April 19, 2001, our stockholders approved an amendment to our certificate of incorporation. Among other things, the amendment reclassified our common stock as Class B common stock and effected a one-for-three reverse split of our Class B common stock effective April 19, 2001. The amendment also authorized a new class of common stock with one-tenth of a vote per share designated as Class A common stock. Our board of directors also approved a dividend of two shares of Class A common stock for each share of Class B common stock, after the one-for-three reverse split, held of record at the close of business April 19, 2001.

Each share of Class A common stock outstanding at the time of the declaration of any dividend or other distribution payable in cash upon the shares of Class B common stock is entitled to a dividend or distribution payable at the same time and to stockholders of record on the same date in an amount at least 10% greater than any dividend declared upon each share of Class B common stock. In the event of our merger or consolidation with or into another entity, the holders of Class A common stock and the holders of Class B common stock are entitled to receive the same per share consideration in such merger or consolidation. In the event of our liquidation, dissolution or winding-up, any assets available to common stockholders will be distributed pro-rata to the holders of Class A common stock and Class B common stock after payment of all our obligations.

In April 2006, our board of directors approved a four-for-three stock split of our Class A common stock and our Class B common stock effected in the form of a 331/3% stock dividend to stockholders of record at the close of business April 17, 2006 and paid on April 26, 2006.

In March 2007, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission (SEC) Rule 10b-18 and in privately negotiated transactions. We purchased 214,343 and 266,426 shares of our Class A common stock under this program during 2008 and 2007, respectively. As of December 31, 2008, our treasury stock consisted of 625,699 and 72,465 shares of Class A common stock and Class B

common stock, respectively. As of December 31, 2007, our treasury stock consisted of 411,356 and 72,465 shares of Class A common stock and Class B common stock, respectively.

In February 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions.

14 — Stock Compensation Plans

Equity Incentive Plans

During 1996, we adopted an Equity Incentive Plan for Employees. During 2001, we adopted a nearly identical plan that made a total of 2,666,667 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2005, an amendment to the plan made a total of 4,000,000 shares of Class A common stock available for issuance. During 2007, we adopted a nearly identical plan that made a total of 3,500,000 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. Each plan provides for the granting of awards by our board of directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. No stock appreciation rights have been issued.

During 1996, we adopted an Equity Incentive Plan for Directors. During 2001, we adopted a nearly identical plan that made 355,556 shares of Class A common stock available for issuance to our directors and those of our subsidiaries and affiliates. During 2007, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance to our directors and the directors of our subsidiaries and affiliates. We may make awards in the form of stock options. The plan also provides for the issuance of 311 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2008, we had 302,499 unexercised options under these plans. In addition, we issued 4,665, 4,976 and 3,417 shares of restricted stock on January 2, 2008, 2007 and 2006, respectively.

Effective January 1, 2006, we adopted FAS No. 123 (R), which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our results of operations. In determining the expense to be recorded for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The significant assumptions utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility. The risk-free interest rate is the implied yield currently available on U.S. Treasury zero coupon issues with a remaining term equal to the expected term used as the assumption in the model. The expected term of an option award is based on historical experience of similar awards. The dividend yield is determined by dividing the per share dividend by the grant date stock price. The expected volatility is based on the volatility of our stock price over a historical period comparable to the expected term.

The weighted-average grant date fair value of options granted during 2008 was \$2.06. We calculated this fair value based upon a risk-free interest rate of 2%, expected life of 3 years, expected volatility of 21% and expected dividend yield of 2%.

The weighted-average grant date fair value of options granted during 2007 was \$1.15. We calculated this fair value based upon a risk-free interest rate of 3%, expected life of 3 years, expected volatility of 20% and expected dividend yield of 2%.

The weighted-average grant date fair value of options granted during 2006 was \$3.05. We calculated this fair value based upon a risk-free interest rate of 5%, expected life of 3 years, expected volatility of 19% and expected dividend yield of 2%.

Under FAS No. 123(R), the compensation expense for the stock compensation plans that we charged against income before income taxes was \$205,288, \$343,442 and \$268,805 for the years ended December 31, 2008, 2007 and 2006, respectively, with a corresponding income tax benefit of \$71,851, \$120,205 and \$94,082. As of December 31, 2008 and 2007, our total unrecognized compensation cost related to nonvested share-based compensation granted under the plan was \$257,610 and \$259,908, respectively. We expect to recognize this cost over a weighted average period of 2.7 years.

FAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FIN No. 44 and EITF 00-23, which states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options granted to the employees and directors of Donegal Mutual, the employer of record for the majority of employees that provide services to us. Implied dividends of \$1,749,063, \$65,179 and \$1,858,525 were recorded for the years ended December 31, 2008, 2007 and 2006, respectively.

Cash received from option exercises under all stock compensation plans for the years ended December 31, 2008, 2007 and 2006 was \$2,358,916, \$1,768,799 and \$4,693,001, respectively. The actual tax benefit realized for the tax deductions from option exercises of share-based compensation was \$683,881, \$854,945 and \$2,298,865 for the years ended December 31, 2008, 2007 and 2006, respectively.

All options issued prior to 2001 converted to options on Class A and Class B common stock as a result of our recapitalization. No further shares are available for plans in effect prior to 2008.

Information regarding activity in our stock option plans follows:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2005	2,282,107	\$12.02
Granted – 2006	1,055,667	20.98
Exercised – 2006	(601,869)	7.80
Forfeited – 2006	(52,078)	14.52
Outstanding at December 31, 2006	2,683,827	16.44
Granted – 2007	20,500	21.00
Exercised – 2007	(246,327)	7.18
Forfeited – 2007	(73,278)	19.17
Outstanding at December 31, 2007	2,384,722	17.36
Granted – 2008	1,368,500	17.52
Exercised – 2008	(247,955)	9.51
Forfeited – 2008	(82,835)	17.80
Outstanding at December 31, 2008	3,422,432	\$17.98
Exercisable at:		
December 31, 2006	824,681	\$11.32
December 31, 2007	1,303,097	\$15.90
December 31, 2008	1,767,810	\$17.74

Shares available for future option grants at December 31, 2008 total 2,563,835 shares under all plans.

The following table summarizes information about fixed stock options at December 31, 2008:

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
\$15.75	1,094,765	1.5 years	1,094,765

17.50	1,305,500	4.5 years	—
17.65	4,000	1.5 years	4,000
18.70	3,000	4.5 years	—
21.00	992,167	3.0 years	661,379
21.00	23,000	4.0 years	7,666
Total	3,422,432		1,767,810

Employee Stock Purchase Plans

During 1996, we adopted an Employee Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance.

The 2001 plan extends over a 10-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85% of the fair market value of our Class A common stock on the last day before the first day of each enrollment period (June 1 and December 1 of each year) under the plan or 85% of the fair market value of our common stock on the last day of each subscription period (June 30 and December 31 of each year).

A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 2006	\$11.77	10,763
July 1, 2006	15.45	9,531
January 1, 2007	15.02	10,929
July 1, 2007	12.67	13,264
January 1, 2008	12.98	14,593
July 1, 2008	13.49	11,498

On January 1, 2009, we issued an additional 10,770 shares at a price of \$14.25 per share under this plan.

Agency Stock Purchase Plans

During 1996, we adopted an Agency Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. The plan provides for agents of our affiliated companies to invest up to \$12,000 per subscription period (April 1 to September 30 and October 1 to March 31 of each year) under various methods. We issue stock at the end of each subscription period at a price equal to 90% of the average market price during the last ten trading days of each subscription period. During 2008, 2007 and 2006, we issued 48,054, 58,255 and 52,500 shares, respectively, under this plan. Expense recognized under the plan was not material.

15 — Statutory Net Income, Capital and Surplus and Dividend Restrictions

The following is selected information, as filed with insurance regulatory authorities, for our insurance subsidiaries as determined in accordance with accounting practices prescribed or permitted by such insurance regulatory authorities:

	2008	2007	2006
Atlantic States			
Statutory capital and surplus	\$182,403,593	\$180,739,409	\$169,947,815
Statutory unassigned surplus	\$128,742,729	\$127,078,545	\$116,286,951
Statutory net income	\$ 18,412,955	\$ 24,052,423	\$ 26,734,985

Southern			
Statutory capital and surplus	\$ 64,272,437	\$ 64,507,274	\$ 62,201,936
Statutory unassigned surplus	\$ 15,154,851	\$ 15,389,688	\$ 13,084,350
Statutory net income	\$ 1,608,947	\$ 5,046,129	\$ 5,905,912

Le Mars			
Statutory capital and surplus	\$ 27,914,815	\$ 28,311,698	\$ 25,415,894
Statutory unassigned surplus	\$ 15,322,075	\$ 15,718,958	\$ 12,823,154
Statutory net income	\$ 1,886,785	\$ 5,127,324	\$ 5,096,706

Peninsula			
Statutory capital and surplus	\$ 39,137,131	\$ 36,904,467	\$ 33,307,701
Statutory unassigned surplus	\$ 21,337,717	\$ 19,105,053	\$ 15,508,287
Statutory net income	\$ 4,082,064	\$ 5,037,902	\$ 5,295,045

	2008 (unaudited)	2007 (unaudited)	2006 (unaudited)
Sheboygan			
Statutory capital and surplus	\$11,176,704	\$10,644,246	\$6,856,654
Statutory unassigned (deficit) surplus	\$ (855,467)	\$ 7,144,246	\$6,856,654
Statutory net (loss) income	\$ (1,110,861)	\$ 632,202	\$ 784,057

Our principal source of cash for payment of dividends are dividends from our insurance subsidiaries. State insurance laws require our insurance subsidiaries to maintain certain minimum capital and surplus on a statutory basis. Our insurance subsidiaries are subject to regulations that restrict payment of dividends from statutory surplus and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to Risk Based Capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2008, our insurance subsidiaries had statutory capital and surplus substantially above the RBC requirements. Amounts available for distribution to us as dividends from our insurance subsidiaries without prior approval of insurance regulatory authorities in 2009 are \$18,412,955 from Atlantic States, \$1,608,947 from Southern, \$2,791,482 from Le Mars, \$3,913,713 from Peninsula and \$0 from Sheboygan.

16 — Reconciliation of Statutory Filings to Amounts Reported Herein

Our insurance subsidiaries are required to file statutory financial statements with state insurance regulatory authorities. Accounting principles used to prepare these statutory financial statements differ from financial statements prepared on the basis of GAAP.

Reconciliations of statutory net income and capital and surplus, as determined using statutory accounting principles (SAP), to the amounts included in the accompanying financial statements are as follows:

	Year Ended December 31,		
	2008	2007	2006
Statutory net income of insurance subsidiaries	\$ 25,946,589	\$ 39,263,778	\$ 43,032,648

Increases (decreases):

Deferred policy acquisition costs	3,306,209	1,496,143	1,262,336
Deferred federal income taxes	811,722	(1,029,042)	(1,085,320)
Salvage and subrogation recoverable	270,000	131,000	(167,000)
Consolidating eliminations and adjustments	(23,708,578)	(17,731,328)	(10,686,208)
Parent-only net income	18,916,036	16,149,354	7,858,266
Net income as reported herein	\$ 25,541,978	\$ 38,279,905	\$ 40,214,722

	December 31,		
	2008	2007	2006
Statutory capital and surplus of insurance subsidiaries	\$324,904,680	\$310,462,848	\$290,873,346
Increases (decreases):			
Deferred policy acquisition costs	29,541,281	26,235,072	24,738,929
Deferred federal income taxes	(5,914,123)	(7,918,623)	(6,271,094)
Salvage and subrogation recoverable	8,665,000	8,275,000	8,144,000
Non-admitted assets and other adjustments, net	2,795,785	1,906,929	1,117,248
Fixed maturities	(3,419,625)	4,637,841	1,574,902
Parent-only equity and other adjustments	7,010,867	9,091,124	624,931
Stockholders' equity as reported herein	\$363,583,865	\$352,690,191	\$320,802,262

17 — Supplementary Cash Flow Information

The following reflects income taxes and interest paid during 2008, 2007 and 2006:

	2008	2007	2006
Income taxes	\$9,325,000	\$11,300,000	\$13,125,000
Interest	\$2,040,017	\$ 2,905,512	\$ 2,755,861

18 — Earnings Per Share

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than those declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share pursuant to FAS No. 128, "Earnings Per Share." The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class.

A reconciliation of the numerators and denominators used in the basic and diluted per share computations for our Class A common stock is presented below:

(dollars in thousands, except per share data)

Year Ended December 31,	2008	2007	2006
Basic earnings per share:			
Numerator:			
Allocation of net income	\$ 20,404	\$ 30,514	\$ 31,985
Denominator:			
Weighted-average shares outstanding	19,866,099	19,685,674	19,391,664
Basic earnings per share	\$ 1.03	\$ 1.55	\$ 1.65
Diluted earnings per share:			
Numerator:			
Allocation of net income	\$ 20,404	\$ 30,514	\$ 31,985
Denominator:			
Number of shares used in basic computation	19,866,099	19,685,674	19,391,664
Weighted-average effect of dilutive securities			
Add: Director and employee stock options	89,419	277,184	604,042
Number of shares used in per share computations	19,955,518	19,962,858	19,995,706
Diluted earnings per share	\$ 1.02	\$ 1.53	\$ 1.60

The following information was used in the basic and diluted per share computations for our Class B common stock:

(dollars in thousands, except per share data)

Year Ended December 31,	2008	2007	2006
Basic and diluted earnings per share:			
Numerator:			
Allocation of net income	\$ 5,138	\$ 7,766	\$ 8,230
Denominator:			
Weighted-average shares outstanding	5,576,775	5,576,775	5,576,775
Basic and diluted earnings per share	\$ 0.92	\$ 1.39	\$ 1.48

We did not include the following options to purchase shares of common stock in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

	2008	2007	2006
Options excluded from diluted earnings per share	1,034,500	1,049,667	1,049,667

19 — Condensed Financial Information of Parent Company

Condensed Balance Sheets

(in thousands)

December 31,	2008	2007
Assets		
Fixed-maturity investments	\$ —	\$ 5,110
Investment in subsidiaries/affiliates (equity method)	366,252	353,147
Short-term investments	12,836	24,203
Cash	1,612	1,517
Property and equipment	1,067	1,137
Other	594	1,436
Total assets	\$382,361	\$386,550
Liabilities and Stockholders' Equity		
Liabilities		
Cash dividends declared to stockholders	\$ 2,602	\$ 2,210
Subordinated debentures	15,465	30,929
Other	710	721
Total liabilities	18,777	33,860
Stockholders' equity	363,584	352,690
Total liabilities and stockholders' equity	\$382,361	\$386,550

Condensed Statements of Income and Comprehensive Income
(in thousands)

Year Ended December 31,	2008	2007	2006
Statements of Income			
Revenues			
Dividends from subsidiaries	\$20,000	\$18,000	\$10,000
Other	1,785	1,950	1,642
Total revenues	21,785	19,950	11,642
Expenses			
Operating expenses	1,558	1,896	2,118
Interest	1,822	2,886	2,801
Total expenses	3,380	4,782	4,919
Income before income tax benefit and equity in undistributed net income of subsidiaries	18,405	15,168	6,723
Income tax benefit	(511)	(981)	(1,136)
Income before equity in undistributed net income of subsidiaries	18,916	16,149	7,859
Equity in undistributed net income of subsidiaries	6,626	22,131	32,356
Net income	\$25,542	\$38,280	\$40,215
Statements of Comprehensive Income			
Net income	\$25,542	\$38,280	\$40,215
Other comprehensive (loss) income, net of tax			
Unrealized (loss) gain — parent	(60)	102	(52)
Unrealized (loss) gain — subsidiaries	(5,201)	1,811	2,581
Other comprehensive (loss) income, net of tax	(5,261)	1,913	2,529
Comprehensive income	\$20,281	\$40,193	\$42,744

Condensed Statements of Cash Flows
(in thousands)

Year Ended December 31,	2008	2007	2006
Cash flows from operating activities:			
Net income	\$ 25,542	\$ 38,280	\$ 40,215
Adjustments:			
Equity in undistributed net income of subsidiaries	(6,626)	(22,131)	(32,356)
Other	924	254	546
Net adjustments	(5,702)	(21,877)	(31,810)
Net cash provided	19,840	16,403	8,405
Cash flows from investing activities:			
Net sale (purchase) of fixed maturities	5,214	2,000	(2,917)
Net sale (purchase) of short-term investments	11,367	(9,174)	(5,598)
Net purchase of property and equipment	(408)	(428)	(546)
Investment in subsidiaries	(11,568)	(50)	(200)
Other	110	189	208
Net cash provided (used)	4,715	(7,463)	(9,053)
Cash flows from financing activities:			
Cash dividends paid	(10,026)	(8,627)	(7,782)
Issuance of common stock	3,857	3,543	6,307
Tax benefit on exercise of stock options	684	855	2,299
Redemption of subordinated debentures	(15,464)	—	—
Repurchase of treasury stock	(3,511)	(4,308)	—
Net cash (used) provided	(24,460)	(8,537)	824
Net change in cash	95	403	176
Cash at beginning of year	1,517	1,114	938
Cash at end of year	\$ 1,612	\$ 1,517	\$ 1,114

20 — Segment Information

We have three reportable segments which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, our insurance subsidiaries market personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

We evaluate the performance of the personal lines and commercial lines primarily based upon our insurance subsidiaries' underwriting results as determined under SAP for our total business.

We do not allocate assets to the personal and commercial lines and review them in total for purposes of decision-making. We operate only in the United States and no single customer or agent provides 10 percent or more of our revenues.

Financial data by segment is as follows:

	2008	2007	2006
	(in thousands)		

Revenues			
Premiums earned:			
Commercial lines	\$121,567	\$113,642	\$115,527
Personal lines	225,143	196,429	185,951
SAP premiums earned	346,710	310,071	301,478
GAAP adjustments	(135)	—	—
GAAP premiums earned	346,575	310,071	301,478
Net investment income	22,756	22,785	21,320
Realized investment (losses) gains	(2,971)	2,051	1,830
Other	5,952	5,711	5,339
Total revenues	\$372,312	\$340,618	\$329,967

Income before income tax expense:

Underwriting income (loss):			
Commercial lines	\$ 13,819	\$ 22,744	\$ 22,495
Personal lines	(7,609)	1,736	9,288
SAP underwriting income	6,210	24,480	31,783
GAAP adjustments	3,530	2,603	1,270
GAAP underwriting income	9,740	27,083	33,053
Net investment income	22,756	22,785	21,320
Realized investment (losses) gains	(2,971)	2,051	1,830
Other	2,567	930	419
Income before income tax expense	\$ 32,092	\$ 52,849	\$ 56,622

21 — Guaranty Fund and Other Insurance-Related Assessments

Our insurance subsidiaries accrue for guaranty fund and other insurance-related assessments in accordance with Statement of Position (SOP) 97-3, “Accounting by Insurance and Other Enterprises for Insurance-Related Assessments.” SOP 97-3 provides guidance for determining when an entity should recognize a liability for guaranty fund and other insurance-related assessments, how to measure that liability and when an asset may be recognized for the recovery of such assessments through premium tax offsets or policy surcharges. Our insurance subsidiaries’ liabilities for guaranty fund and other insurance-related assessments were \$2,603,899 and \$2,560,904 at December 31, 2008 and 2007, respectively. These liabilities included \$307,456 and \$358,399 related to surcharges collected by our insurance subsidiaries on behalf of regulatory authorities for 2008 and 2007, respectively.

22 — Interim Financial Data (unaudited)

	2008			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$82,007,766	\$87,329,195	\$88,170,757	\$89,067,548
Total revenues	89,792,103	93,970,947	92,708,575	95,840,537
Net losses and loss expenses	53,785,061	56,364,145	54,700,316	59,451,442
Net income	6,559,083	6,318,177	6,270,421	6,394,297
Net earnings per common share:				
Class A common stock — basic	0.26	0.25	0.25	0.26
Class A common stock — diluted	0.26	0.25	0.25	0.26
Class B common stock — basic and diluted	0.24	0.23	0.23	0.23

	2007			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$76,697,819	\$77,574,827	\$77,609,940	\$78,188,948
Total revenues	83,682,016	84,605,176	85,440,831	86,890,271
Net losses and loss expenses	50,595,427	40,548,719	41,011,053	45,628,433
Net income	5,489,938	10,780,956	11,212,428	10,796,583
Earnings per common share:				
Class A common stock — basic	0.22	0.44	0.45	0.44
Class A common stock — diluted	0.22	0.43	0.45	0.43
Class B common stock — basic and diluted	0.20	0.39	0.41	0.39

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, “Quantifying Financial Statement Misstatements.” SAB No. 108 provides guidance on how to evaluate prior period financial statement misstatements for purposes of assessing their materiality in the current period. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. There are two widely recognized methods for quantifying the effects on the financial statements: the “rollover” or income statement method and the “iron curtain” or balance sheet method. SAB No. 108 requires that we consider both the rollover and iron curtain methods (dual method) when quantifying misstatements in the financial statements. The rollover method quantifies a misstatement based on the amount of errors originating in the current year income statement. The iron curtain method quantifies a misstatement based on the effects of correcting the misstatement existing in the balance sheet at the end of the current year, irrespective of the timing of the misstatement’s origination.

During the fourth quarter of 2008, we discovered errors in amounts recorded for losses and loss expenses incurred during the first three quarters of 2008. Pursuant to SAB No. 108, we determined that the misstatements were not material to the financial statements issued for these periods.

The following tables present interim financial data as adjusted, adjustment amounts and financial data as previously reported for the first three quarters of 2008:

	First Quarter 2008		
	As Adjusted	Adjustment	As Previously Reported
	Net premiums earned	\$82,007,766	\$ —
Total revenues	89,792,103	—	89,792,103
Net losses and loss expenses	53,785,061	255,230	53,529,831
Net income	6,559,083	(165,900)	6,724,983
Net earnings per common share:			
Class A common stock — basic	0.26	(0.01)	0.27
Class A common stock — diluted	0.26	(0.01)	0.27
Class B common stock — basic and diluted	0.24	(0.01)	0.25
Loss ratio	65.6%	0.3%	65.3%

	Second Quarter 2008		
	As Adjusted	Adjustment	As Previously Reported
	Net premiums earned	\$87,329,195	\$ —
Total revenues	93,970,947	—	93,970,947
Net losses and loss expenses	56,364,145	884,218	55,479,927
Net income	6,318,177	(574,741)	6,892,918
Net earnings per common share:			
Class A common stock — basic	0.25	(0.03)	0.28
Class A common stock — diluted	0.25	(0.03)	0.28
Class B common stock — basic and diluted	0.23	(0.02)	0.25
Loss ratio	64.5%	1.0%	63.5%

	Third Quarter 2008		
	As Adjusted	Adjustment	As Previously Reported
	Net premiums earned	\$88,170,757	\$ —
Total revenues	92,708,575	—	92,708,575
Net losses and loss expenses	54,700,316	1,465,630	53,234,686
Net income	6,270,421	(952,659)	7,223,080

Net earnings per common share:

Class A common stock — basic	0.25	(0.04)	0.29
Class A common stock — diluted	0.25	(0.04)	0.29
Class B common stock — basic and diluted	0.23	(0.03)	0.26
Loss ratio	62.0%	1.6%	60.4%

REPORT OF Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three year period ended December 31, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Donegal Group Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 11, 2009 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP
Philadelphia, Pennsylvania
March 11, 2009

MANAGEMENT'S Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, our management has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008, based on the framework and criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework").

Based on our evaluation under the COSO Framework, our management has concluded that our internal control over financial reporting was effective as of December 31, 2008.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Because of its inherent limitations, a system of internal control over financial reporting may not prevent or detect all 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 the degree of compliance with the policies or procedures may deteriorate.

Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2008 included internal controls at all consolidated entities other than Sheboygan Falls Insurance Company (Sheboygan), which was acquired on December 1, 2008. Our management has not evaluated Sheboygan's internal controls over financial reporting, and our management's conclusion regarding the effectiveness of internal controls over financial reporting does not extend to Sheboygan's internal controls.

The effectiveness of our internal control over financial reporting has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Donald H. Nikolaus
President and Chief Executive Officer



Jeffrey D. Miller
Senior Vice President and Chief Financial Officer

March 11, 2009

REPORT OF Independent Registered Public Accounting Firm

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited Donegal Group Inc.'s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Donegal Group Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit 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 audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

In our opinion, Donegal Group Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Donegal Group Inc. acquired Sheboygan Falls Insurance Company on December 1, 2008 and management excluded from its assessment of the effectiveness of Donegal Group Inc.'s internal control over financial reporting as of December 31, 2008, Sheboygan Falls Insurance Company's internal control over financial reporting associated with total assets of approximately \$26 million and net premiums earned of approximately \$500,000 included in the consolidated financial statements of Donegal Group Inc. as of and for the year ended December 31, 2008. Our audit of internal control over financial reporting of Donegal Group Inc. also excluded an evaluation of the internal control over financial reporting of Sheboygan Falls Insurance Company as of December 31, 2008.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2008, and our report dated March 11, 2009 expressed an unqualified opinion on those consolidated financial statements.

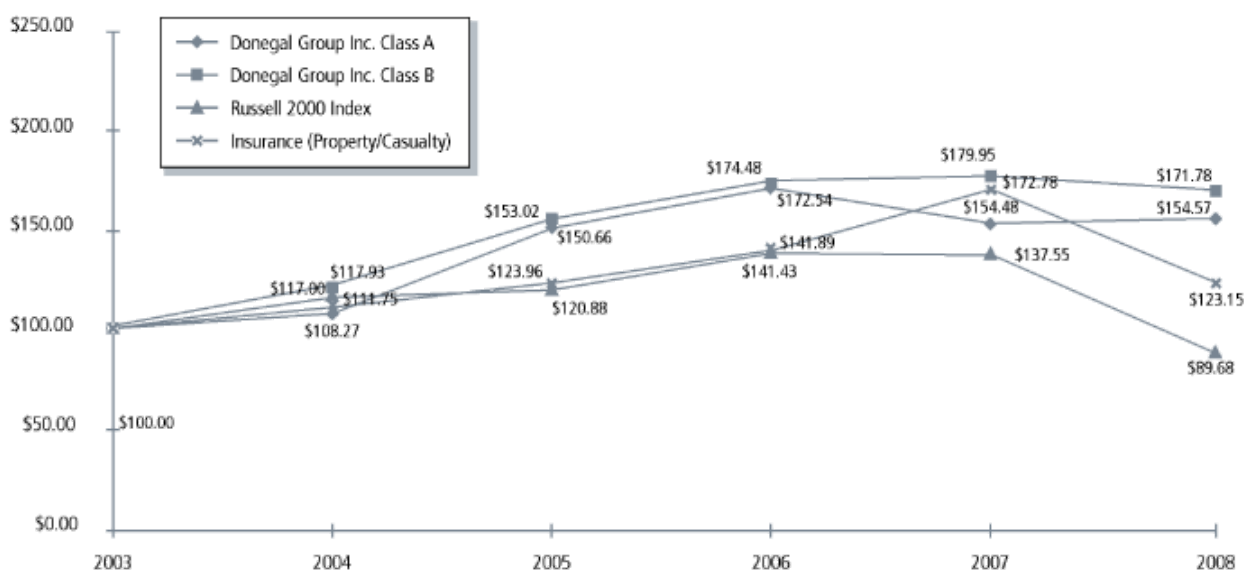
KPMG LLP
Philadelphia, Pennsylvania
March 11, 2009

COMPARISON OF Total Return on Our Common Stock with Certain Averages

The following graph provides an indicator of cumulative total stockholder returns on our common stock compared to the Russell 2000 Index and a peer group of property and casualty insurance companies selected by Value Line, Inc. The members of the peer group are as follows: 21st Century Holding Co., ACA Capital Holdings Inc., Acceptance Insurance Cos. Inc., ACE Ltd., ACMAT Corp., Affirmative Insurance Holdings Inc., Allied World Assurance Co. Holdings Ltd., Allstate Corp., American Financial Group Inc., American Physicians Capital Inc., American Safety Insurance Holdings Ltd., AMERISAFE Inc., AmTrust Financial Services Inc., Anthony Clark International Insurance Brokers Ltd., Arch Capital Group Ltd., Argo Group International Holdings Ltd., Aspen Insurance Holdings Ltd., AssuranceAmerica Corp., Assurant Inc., Axis Capital Hldgs Ltd (Bermuda), Baldwin & Lyons Inc. (Cl A), Baldwin & Lyons Inc. (Cl B), Brooke Corp., Chubb Corp., Cincinnati Financial Corp., CNA Financial Corp., CNA Surety Corp., Cninsure Inc., CRM Holdings Ltd., Donegal Group Inc. (Cl B), eHealth Inc., EMC Insurance Group Inc., Employers Holdings Inc., Endurance Specialty Holdings Ltd., Erie Indemnity Co. (Cl A), Fairfax Financial Holdings Ltd., Fidelity National Financial Inc., First Mercury Financial Corp., Flagstone Reinsurance Holdings Ltd., Fremont Michigan InsuraCorp Inc., GAINSCO Inc., Hallmark Financial Services Inc., Harleysville Group Inc., HCC Insurance Holdings Inc., Homeowners Choice Inc., Industrial Alliance Insurance & Financial Services Inc., Infinity Property & Casualty Corp., Kingsway Financial Services Inc., Maiden Holdings Ltd., Markel Corp., Meadowbrook Insurance Group Inc., Mercer Insurance Group Inc., Mercury General Corp., Montpelier Re Holdings Ltd., National Interstate Corp., Old Republic International Corp., OneBeacon Insurance Group Ltd. (Cl A), PMA Capital Corp. (Cl A), PMI Group Inc., Progressive Corp., RLI Corp., Safety Insurance Group Inc., SeaBright Insurance Holdings Inc., Selective Insurance Group Inc., State Auto Financial Corp., Sun Life Financial Inc., The Hanover Insurance Group Inc., Tower Group Inc., Travelers Cos. Inc., United America Indemnity Ltd., United Fire & Casualty Co., Universal Insurance Holdings Inc., Validus Holdings Ltd., W.R. Berkley Corp., XL Capital Ltd. (Cl A), Zenith National Insurance Corp.

Comparison of Five-Year Cumulative Total Return*

Donegal Group Inc. Class A, Donegal Group Inc. Class B, Russell 2000 Index and Value Line Insurance (Property/Casualty)



Assumes \$100 invested at the close of trading on December 31, 2003 in Donegal Group Inc. Class A common stock, Donegal Group Inc. Class B common stock, Russell 2000 Index and Value Line Insurance (Property/Casualty).

	2003	2004	2005	2006	2007	2008
Donegal Group Inc. Class A	\$100.00	\$108.27	\$150.66	\$172.54	\$154.48	\$171.78
Donegal Group Inc. Class B	100.00	117.93	153.02	174.48	179.95	171.78
Russell 2000 Index	100.00	117.00	120.88	141.43	137.55	89.68
Insurance (Property/Casualty)	100.00	111.75	123.96	141.89	172.78	123.15

* Cumulative total return assumes reinvestment of dividends.

CORPORATE Information

Annual Meeting

April 16, 2009 at the Company's headquarters at 10:00 a.m.

Form 10-K

A copy of Donegal Group's Annual Report on Form 10-K will be furnished free upon written request to Jeffrey D. Miller, Senior Vice President and Chief Financial Officer, at the corporate address.

Market Information

Donegal Group's Class A common stock and Class B common stock are traded on the NASDAQ Global Select Market under the symbols "DGICA" and "DGICB." The following table shows the dividends paid per share and the stock price range for each quarter during 2008 and 2007:

Quarter	High	Low	Cash Dividend Declared Per Share
2007 - Class A			
1st	\$20.12	\$16.59	\$ —
2nd	17.77	14.43	.09
3rd	17.45	14.19	.09
4th	18.10	15.57	.18
2007 - Class B			
1st	\$19.13	\$16.09	\$ —
2nd	17.56	16.30	.0775
3rd	20.22	14.50	.0775
4th	19.99	17.90	.155
2008 - Class A			
1st	\$18.00	\$15.60	\$ —
2nd	17.95	15.51	.105
3rd	23.00	15.31	.105
4th	18.00	11.24	.21
2008 - Class B			
1st	\$19.98	\$17.67	\$ —
2nd	19.01	17.00	.0925
3rd	18.93	17.00	.0925
4th	18.76	11.04	.185

Corporate Offices

1195 River Road
P.O. Box 302
Marietta, Pennsylvania 17547-0302
(800) 877-0600
E-mail Address: info@donegalgroup.com
Donegal Web Site: www.donegalgroup.com

Transfer Agent

Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078
(800) 317-4445
Web Site: www.computershare.com
Hearing Impaired: TDD: 800-952-9245

Dividend Reinvestment and Stock Purchase Plan

The Company offers a dividend reinvestment and stock purchase plan through its transfer agent.

For information contact:

Donegal Group Inc.
Dividend Reinvestment and Stock Purchase Plan
Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078

Stockholders

The following represent the number of common stockholders of record as of December 31, 2008:

Class A common stock	1,132
Class B common stock	409

SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of the following companies, except as noted:

Name	State of Formation
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia
Le Mars Insurance Company	Iowa
The Peninsula Insurance Company	Maryland
Peninsula Indemnity Company*	Maryland
Donegal Financial Services Corporation**	Delaware
Province BankFSB***	U.S.
Sheboygan Falls Insurance Company	Wisconsin

* Wholly owned by The Peninsula Insurance Company.

** Registrant owns 48.2%. Donegal Mutual Insurance Company owns 51.8%.

*** Wholly owned by Donegal Financial Services Corporation.

REPORT AND CONSENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 11, 2009 with respect to the consolidated financial statements of Donegal Group Inc. and subsidiaries included the related financial statement schedule as of December 31, 2008 and 2007, and for each of the years in the three-year period ended December 31, 2008, included in the annual report on Form 10-K. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits. In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-93785, 333-94301, 333-89644, 333-62970, 333-62974, 333-62976 and 333-142614) on Form S-8 and registration statements (Nos. 333-59828 and 333-63102) on Form S-3 of Donegal Group Inc. of our reports dated March 11, 2009, with respect to the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2008, and the related financial statement schedule and the effectiveness of internal control over financial reporting as of December 31, 2008, which reports are incorporated by reference or appear in the December 31, 2008 annual report on Form 10-K of Donegal Group Inc.

Our report, dated March 11, 2009, on the effectiveness of internal control over financial reporting as of December 31, 2008 contains an explanatory paragraph regarding an acquired entity that was excluded from management's assessment and our evaluation of the effectiveness of Donegal Group Inc.'s internal control over financial reporting as of December 31, 2008.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 11, 2009

CERTIFICATION

I, Donald H. Nikolaus, President of Donegal Group Inc., certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2008 of Donegal Group 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 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 15a-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 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.

/s/ Donald H. Nikolaus

Donald H. Nikolaus, President

Date: March 11, 2009

CERTIFICATION

I, Jeffrey D. Miller, Senior Vice President and Chief Financial Officer of Donegal Group Inc., certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2008 of Donegal Group 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 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 15a-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 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.

/s/ Jeffrey D. Miller

Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer

Date: March 11, 2009

Statement of President
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Donald H. Nikolaus, the President of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2008 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Donald H. Nikolaus
Donald H. Nikolaus, President

Date: March 11, 2009

Statement of Chief Financial Officer
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Jeffrey D. Miller, Vice President and Chief Financial Officer of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2008 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Jeffrey D. Miller
Jeffrey D. Miller, Vice President and
Chief Financial Officer

Date: March 11, 2009