

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, 2001  
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

23-2424711

-----  
(State or other jurisdiction of  
incorporation or organization)

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

1195 River Road, Marietta, Pennsylvania

17547

-----  
(Address of principal executive offices)

-----  
(Zip code)

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

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

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

Class A Common Stock, \$.01 par value

-----  
Class B Common Stock, \$.01 par value

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(Title of class)

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.

On March 15, 2002, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was \$27,175,970.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 6,031,892 shares of Class A Common Stock and 2,981,870 shares of Class B Common Stock were outstanding on March 15, 2002.

DOCUMENTS INCORPORATED BY REFERENCE:

- i. Portions of the Registrant's annual report to stockholders for the fiscal year ended December 31, 2001 are incorporated by reference into Parts I, II and IV of this report.
- ii. Portions of the Registrant's proxy statement relating to the annual meeting of stockholders to be held April 18, 2002 are incorporated by reference into Part III of this report.

DONEGAL GROUP INC.  
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PART I

Item 1. Business.

(a) General Development of Business.

Donegal Group Inc. is an insurance holding company formed in August 1986, which is headquartered in Pennsylvania and engages, through its subsidiaries, in the property and casualty insurance business in 14 mid-Atlantic and southeastern states. As used in this Report, "DGI" or the "Company" refers to Donegal Group Inc. and its insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Pioneer Insurance Company ("Pioneer Ohio") and Southern Heritage Insurance Company ("Southern Heritage"). To reduce expenses and enhance operating efficiencies, during 2001 two of DGI's former insurance company subsidiaries, Delaware Atlantic Insurance Company ("Delaware Atlantic") and Pioneer Insurance Company, a New York company ("Pioneer New York"), merged into Atlantic States. Except as otherwise noted, all financial information included in this Report for Atlantic States includes the financial information of those former subsidiaries through the dates of the mergers.

Donegal Mutual Insurance Company (the "Mutual Company") currently owns 63.7% of the outstanding Class A Common Stock and 62.1% of the outstanding Class B Common Stock of the Company. DGI and its subsidiaries and the Mutual Company underwrite a broad line of personal and commercial coverages, consisting of private passenger and commercial automobile, homeowners, commercial multi-peril, workers' compensation and other lines of insurance.

The Company's strategy is to seek growth both internally and through acquisitions. Since the formation of the Company and Atlantic States in 1986, the Company has completed the following acquisitions:

Company Acquired	Year Acquired	Net Premiums Written Year Prior to Acquisition	Net Premiums Written Year Ended December 31, 2001
Southern Insurance Company of Virginia	1988	\$ 1,128,843	\$15,213,371
Delaware Atlantic Insurance Company(1)	1995	2,824,398	--
Pioneer Insurance Company (Ohio)	1997	4,499,273	4,941,980
Southern Heritage Insurance Company	1998	32,002,540	17,226,133
Pioneer Insurance Company (New York)(1)	2001	1,917,723	--

(1) Merged into Atlantic States in 2001.

The Company evaluates other acquisition candidates on a continuing basis. However, there can be no assurance as to whether or when the Company will effect any additional acquisitions.

Atlantic States, which DGI organized in September 1986, participates in an underwriting pool whereby it cedes to the Mutual Company the premiums, losses and loss expenses from all of its insurance business and assumes from the Mutual Company a specified portion of the pooled business, which also includes substantially all of the Mutual Company's property and casualty insurance business. Effective as of October 1, 1986, DGI entered into a pooling agreement with the Mutual Company whereby Atlantic States assumed 35% of the pooled business written or in force on or after October 1, 1986, with the Mutual Company remaining solely responsible for any losses in the pooled business with dates of loss on or before the close of business on September 30, 1986. Pursuant to amendments to the pooling agreement subsequent to October 1, 1986, the Mutual Company has increased the percentage of retrocessions of the pooled business to Atlantic States, and, since July 1, 2000, 70% of the pooled business has been retroceded to Atlantic States. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Item 7 hereof and Note 2 to the Consolidated Financial Statements incorporated by reference herein.

On December 29, 1988, DGI acquired all of the outstanding capital stock of Southern in exchange for a \$3,000,000 equity contribution to Southern. Since January 1, 1991, Southern has ceded to the Mutual Company 50% of its direct premiums written and 50% has been retained by Southern. Because the Mutual Company places substantially all of the business assumed from Southern in the pool, in which DGI has a 70% allocation, DGI's results of operations include approximately 85% of the business written by Southern. See Note 2 to the Consolidated Financial Statements incorporated by reference herein.

As of December 31, 1995, the Company acquired all of the outstanding capital stock of Delaware Atlantic pursuant to a Stock Purchase Agreement dated as of December 21, 1995 between the Company and the Mutual Company. On August 1, 2001, Delaware Atlantic merged into Atlantic States.

As of March 31, 1997, the Company acquired all of the outstanding capital stock of Pioneer Ohio pursuant to a Stock Purchase Agreement dated as of April 7, 1997 between the Company and the Mutual Company. The Company plans to merge Pioneer Ohio into Atlantic States in 2002 upon the receipt of regulatory approval, which is expected prior to June 30, 2002.

On November 17, 1998, DGI purchased all of the outstanding capital stock of Southern Heritage, a Georgia-domiciled property and casualty insurance company, from Southern Heritage Limited Partnership for a purchase price, as finally settled, of \$18,824,950 in cash. The Company plans to merge Southern Heritage into Southern upon the receipt of regulatory approval, which is expected prior to June 30, 2002.

As of January 1, 2001, DGI purchased all of the outstanding capital stock of Pioneer New York from the Mutual Company pursuant to a Stock Purchase Agreement dated as of July 20, 2000. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interest, as both Pioneer New York and the Company are under the common management of the Mutual Company. Accordingly, the Company's financial statements have been restated to include Pioneer New York as a consolidated subsidiary. On September 30, 2001, Pioneer New York merged into Atlantic States.

DGI and the Mutual Company jointly own Donegal Financial Services Corporation ("Donegal Financial"), the holding company for Province Bank FSB ("Province Bank"), a federal savings bank headquartered in Marietta, Pennsylvania. Province Bank opened for business in September 2000, and its deposits are insured by the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation. Donegal Financial's capital stock is owned 55% by the Mutual Company and 45% by the Company.

Effective as of the close of business on April 19, 2001, the Company: (a) effected a one-for-three reverse stock split of its previously authorized Common Stock and redesignated that Common Stock as Class B Common Stock; and (b) declared a dividend of two shares of Class A Common Stock payable on each share of Class B Common Stock then outstanding. As a result of the reverse stock split and the stock dividend, each person who held shares of the Company's previously authorized Common Stock as of the close of business on April 19, 2001 thereafter continued to hold, exclusive of any fractional interest in a share of Class B Common Stock, the same number of shares of the Company's capital stock, two-thirds of which were shares of Class A Common Stock and one-third of which were shares of Class B Common Stock. Except as otherwise required by law, each share of Class A Common Stock is entitled one-tenth of a vote with respect to each matter submitted to the stockholders of the Company for approval and each share of Class B Common Stock is entitled to one vote with respect to each matter submitted to the stockholders of the Company for approval. The Class A Common Stock and the Class B Common Stock vote together as a single class unless otherwise required by law. A slightly higher dividend is paid on the Class A Common Stock than on the Class B Common Stock. All share information set forth in this Report for periods after April 19, 2001 reflects these transactions.

(b) Financial Information About Industry Segments.  
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The Company has three segments, which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Financial information about these segments is set forth in Note 17 to the Consolidated Financial Statements incorporated by reference herein.

(c) Narrative Description of Business.

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RELATIONSHIP WITH THE MUTUAL COMPANY

DGI's insurance operations are interrelated with the insurance operations of the Mutual Company and, because of the percentage of the pooled business assumed by DGI, DGI's results of operations are dependent to a material extent upon the success of the Mutual Company. In addition, various reinsurance agreements exist between the Company's insurance subsidiaries and the Mutual Company. The Mutual Company is responsible for underwriting and marketing the pooled business and provides facilities, employees and services required to conduct the business of DGI on a cost-allocated basis. As of March 12, 2002, the Mutual Company owned 63.5% of DGI's Class A Common Stock and 62.1% of DGI's Class B Common Stock.

Through the pool and through its insurance subsidiaries, DGI writes personal and commercial property and casualty insurance lines, including automobile, homeowners, commercial multi-peril, workers' compensation and other lines of business.

The Mutual Company provides all personnel for the Company and certain of its insurance subsidiaries, including Atlantic States, Southern, Southern Heritage and Pioneer Ohio. Expenses are allocated to the Company, Southern, Southern Heritage and Pioneer Ohio according to a time allocation and estimated usage agreement, and to Atlantic States in relation to the relative participation of the Mutual Company and Atlantic States in the pooling agreement described herein. Expenses allocated to the Company under such agreement were \$29,298,569 in 2001.

The Mutual Company leases office equipment and automobiles from the Company, under a lease dated January 1, 2000. The Mutual Company made lease payments to the Company of \$801,083 in 2001.

Under the terms of the intercompany pooling agreement, Atlantic States cedes to the Mutual Company the premiums, losses and loss expenses on all of its insurance business. Substantially all of the Mutual Company's property and casualty insurance business is included in the pooled business. Pursuant to amendments to the pooling agreement since its commencement on October 1, 1986, the Mutual Company has increased the percentage of retrocessions of the pooled business to Atlantic States, and, as most recently amended, effective as of July 1, 2000, 70% of the pooled business has been retroceded to Atlantic States. All premiums, losses, loss expenses and other underwriting expenses are prorated among the parties on the basis of their participation in the pool. The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties, subject to approval by the Coordinating Committee discussed below. The allocations of pool participation percentages between the Mutual Company and Atlantic States are based on the pool participants' relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and the ability of the Company to raise capital for Atlantic States. The Company does not currently anticipate a further increase in Atlantic States'

percentage of participation in the pool, nor does the Company intend to terminate the participation of Atlantic States in the pooling agreement.

The underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for the participants in the pool than they would experience individually and to spread the risk of loss among all the participants. Each company participating 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 additional capacity exists because such policy exposures are spread among the pool participants, each of which has its own capital and surplus.

DGI and the Mutual Company jointly own Donegal Financial, the holding company for Province Bank, a federal savings bank headquartered in Pennsylvania, the deposits of which are insured by the Savings Association Insurance Fund of the Federal Deposit Insurance Corporation. In connection with the initial capitalization of Province Bank, which opened for business in September 2000, the Mutual Company purchased 55%, for \$3,575,000, and the Company purchased 45%, for \$2,925,000, of the capital stock of Donegal Financial. The Company provided additional cash, in the amount of \$117,000, to Donegal Financial subsequent to September 2000.

The Mutual Company and Province Bank are parties to a lease dated September 1, 2000, whereby Province Bank leases from the Mutual Company 3,600 square feet of one of the Mutual Company's buildings located in Marietta, Pennsylvania for an annual rent based on an independent appraisal. The Mutual Company and Province Bank are also parties to an Administrative Services Agreement dated September 1, 2000, whereby the Mutual Company is obligated to provide various human resource services, principally payroll and employee benefits administration, administrative support, facility and equipment maintenance services and purchasing, to Province Bank, subject to the overall limitation that the costs to be charged by the Mutual Company may not exceed the costs of independent vendors for similar services and further subject to annual maximum cost limitations specified in the Administrative Services Agreement.

All of the Company's officers are officers of the Mutual Company, five of the Company's eight directors are directors of the Mutual Company and two of the Company's executive officers are directors of the Mutual Company. The Company and the Mutual Company maintain a Coordinating Committee, which consists of two outside directors from each of the Company and the Mutual Company, none of whom holds seats on both Boards. Under the Company's and the Mutual Company's By-laws, any new agreement between the Company and the Mutual Company and any proposed change in any existing agreement between the Company and the Mutual Company must first be submitted for approval by the respective Boards of Directors of the Company and the Mutual Company and, if approved, submitted to the Coordinating Committee for approval. The proposed new agreement or change in an existing agreement will receive Coordinating Committee approval only if both of the Company's Coordinating Committee members conclude the new agreement or change in an existing agreement is fair to the Company and its stockholders and if both of the

Mutual Company's members conclude the agreement is fair and equitable to the Mutual Company and its policyholders. The decisions of the Coordinating Committee are binding on the Company and the Mutual Company. The purpose of this provision is to protect the interests of the stockholders of the Company and the interests of the policyholders of the Mutual Company. The Coordinating Committee meets on an as-needed basis.

#### DGI'S BUSINESS STRATEGY

DGI, in conjunction with the Mutual Company, has multiple strategies that the management of DGI believes have resulted in underwriting results that are favorable when compared to those of the property and casualty insurance industry in general over the past five years. The principal strategies comprise the following:

- o A regional company concept designed to provide the advantages of local marketing, underwriting and claims servicing with the economies of scale from centralized accounting, administrative, investment, data processing and other services.
- o An underwriting program and product mix designed to produce a Company-wide underwriting profit, i.e., a combined ratio of less than 100%, from careful risk selection and adequate pricing.
- o A goal of a closely balanced ratio between commercial business and personal business.
- o An agent selection process that focuses on appointing agencies with proven market strategies for the development of profitable business and an agent compensation plan providing for incentive commissions based upon premium volume and profitability and the right to participate in the Company's Agency Stock Purchase Plan.
- o A continuing effort to attract and retain qualified employees who receive incentive compensation based upon underwriting profitability.
- o A goal of expanding operations in current and adjacent states.
- o A goal of obtaining sufficient rate increases in both commercial and personal lines to improve underwriting results while maintaining the existing book of business and preserving the Company's ability to write new business.



PROPERTY AND CASUALTY INSURANCE PRODUCTS AND SERVICES

The following table indicates the percentage of DGI's net premiums written represented by commercial lines and by personal lines for the years ended December 31, 2001, 2000 and 1999:

	Year Ended December 31,		
	2001	2000	1999
Net Premiums Written:			
Commercial.....	36.9%	37.2%	35.1%
Personal.....	63.1	62.8	64.9

The commercial lines consist primarily of automobile, multi-peril and workers' compensation insurance. The personal lines consist primarily of automobile and homeowners insurance. These types of insurance are described in greater detail below:

COMMERCIAL

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

PERSONAL

- o Private passenger automobile -- policies that provide protection against liability for bodily injury and property damage arising from automobile accidents, and provide protection against loss from damage to automobiles owned by the insured.
- o 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.

The following table sets forth the combined ratios of DGI, prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and statutory accounting principles prescribed or permitted by state insurance authorities. The combined ratio is a traditional measure of underwriting profitability. When the combined ratio is under 100%, underwriting results are generally considered profitable. Conversely, when the combined ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. DGI's operating income depends on income from both underwriting operations and investments. DGI's combined ratio for 1999 was adversely impacted by restructuring charges of approximately \$1.6 million.

	Year Ended December 31,		
	2001	2000	1999
GAAP combined ratio.....	103.8%	101.8%	106.5%
Statutory operating ratios:			
Loss ratio.....	70.5	68.8	68.8
Expense ratio.....	31.4	30.9	37.2
Dividend ratio.....	1.0	0.9	0.9
Statutory combined ratio.....	102.9%	100.6%	106.9%
Industry statutory combined ratio(1).....	118.0%	110.5%	107.5%

(1) Source: A.M. Best Company

DGI is required to participate in involuntary insurance programs for automobile insurance, as well as other property and casualty insurance lines, in states in which DGI operates. These programs include joint underwriting associations, assigned risk plans, fair access to insurance requirements (FAIR) plans, reinsurance facilities and windstorm 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. 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 in the voluntary market. During 2001, 2000 and 1999, the Company incurred assessments totaling \$1,286,578, \$813,000 and \$726,000, respectively, from the Pennsylvania Insurance Guaranty Association relating to the insolvencies of two medical malpractice insurers and Reliance Insurance Company.

The following table sets forth the net premiums written and combined ratios by line of insurance for the business of DGI, prepared in accordance with statutory accounting practices prescribed or permitted by state insurance authorities, for the periods indicated.

	Year Ended December 31,		
	2001	2000	1999
	(dollars in thousands)		
<b>Net Premiums Written:</b>			
<b>Commercial:</b>			
Automobile .....	\$16,527	\$15,112	\$12,608
Workers' compensation .....	22,979	21,174	17,519
Commercial multi-peril .....	24,174	21,722	18,949
Other .....	1,725	1,597	1,433
<b>Total commercial .....</b>	<b>65,405</b>	<b>59,605</b>	<b>50,509</b>
<b>Personal:</b>			
Automobile .....	74,396	65,528	61,894
Homeowners .....	31,431	29,413	26,290
Other .....	5,796	5,576	5,179
<b>Total personal .....</b>	<b>111,623</b>	<b>100,517</b>	<b>93,363</b>
<b>Total business .....</b>	<b>\$177,028</b>	<b>\$160,122</b>	<b>\$143,872</b>
<b>Statutory Combined Ratios:</b>			
<b>Commercial:</b>			
Automobile .....	108.9%	99.9%	113.8%
Workers' compensation .....	109.9	91.9	96.7
Commercial multi-peril .....	96.2	102.2	95.9
Other .....	77.0	39.0	80.6
<b>Total commercial .....</b>	<b>103.7</b>	<b>96.2</b>	<b>100.0</b>
<b>Personal:</b>			
Automobile .....	104.5	100.3	106.8
Homeowners .....	101.6	110.9	123.3
Other .....	86.8	103.5	88.0
<b>Total personal .....</b>	<b>102.7</b>	<b>103.6</b>	<b>109.9</b>
<b>Total business .....</b>	<b>102.9%</b>	<b>100.6%</b>	<b>106.9%</b>

**PROPERTY AND CASUALTY UNDERWRITING**

The underwriting department is responsible for the establishment of underwriting and risk selection guidelines and criteria for the various insurance products written by DGI. The underwriting department, in conjunction with the marketing representatives, works closely with DGI's independent insurance agents to insure a comprehensive knowledge on the part of the agents of DGI's underwriting requirements and risk selection process.

DGI's underwriting and pricing strategy is designed to produce an underwriting profit resulting in a Company-wide combined ratio below 100%. DGI and the Mutual Company have a conservative underwriting philosophy, which, in the opinion of management, is one of the prime reasons for DGI's favorable loss ratios relative to the property and casualty insurance industry over the last five years.

The underwriting department has over time initiated risk inspection procedures and underwriting analyses on a per risk and class of business basis. It has also automated underwriting processing utilizing technology such as bar coding. Management has established monitoring and auditing processes to verify compliance with underwriting requirements and procedures.

The underwriting department and the research and development department are responsible for the development of new insurance products and enhancements of existing products. Underwriting profitability is enhanced by the creation of niche products focused on classes of business which traditionally have provided underwriting profits.

#### MARKETING

DGI's insurance products, together with the products of its subsidiaries and the Mutual Company, are marketed through approximately 1,500 insurance agencies. Business is written by either DGI or the Mutual Company depending upon geographic location, agency license and product. Management has developed an agency appointment procedure that focuses on appointing agencies with proven marketing strategies for the development of profitable business. DGI regularly evaluates its agency force and continues to strive to obtain and retain a significant position within each agency relative to the amount of business similar to that of DGI placed by the agency with other insurers. DGI and the Mutual Company have developed a successful contingent commission plan for agents, under which additional commissions are payable based upon the volume of premiums produced and the profitability of the business of the agency written by DGI and the Mutual Company. Management believes the contingent commission program and the Company's Agency Stock Purchase Plans have enhanced the ability of DGI and the Mutual Company to write profitable business.

DGI has granted certain agents the authority to bind insurance within underwriting and pricing limits specified by DGI without the prior approval of DGI. However, DGI generally reviews all coverages placed by its agents and, subject to applicable insurance regulations, may cancel the coverage if it is inconsistent with DGI's guidelines.

DGI believes that its regional structure enables it to compete effectively with large national companies. This regional structure permits DGI to take advantage of its knowledge of local operating territories and the opportunity to form strong, long-term relationships with the agents that represent DGI and the Mutual Company.

DGI and the Mutual Company have developed comprehensive growth strategies for each of the commercial and personal lines of insurance business. DGI has focused on the small- to medium-sized commercial insurance markets, which have traditionally been a more stable and profitable segment of the property and casualty insurance business than the large commercial insurance markets. Commercial lines marketing is characterized by account selling, in which multiple lines of insurance are offered to a single policyholder.

DGI believes that competitive and comprehensive products targeted to selected classes of personal lines business, along with excellent service to agents and policyholders, provides a foundation for growth and profitability. As is customary in the industry, insureds are encouraged to place both their homeowners and personal automobile insurance with DGI or the Mutual Company and are offered a discount for doing so.

#### CLAIMS

The claims department develops and implements policies and procedures for the establishment of claim reserves and the timely resolution and payment of claims. The management and staff of the claims department resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters.

Insurance claims are normally investigated and adjusted by internal claims adjusters and supervisory personnel. Independent adjusters are employed as needed to handle claims in territories in which the volume of claims is not sufficient to justify hiring internal claims adjusters. The litigation and personal injury sections manage all claims litigation, and all claims above \$25,000 require home office review and settlement authorization.

Field office staffs are supported by home office technical, litigation, material damage, subrogation and medical audit personnel who provide specialized claims support. An investigative unit attempts to prevent fraud and abuse and to control losses.

#### LIABILITIES FOR LOSSES AND LOSS EXPENSES

Liabilities for losses and loss expenses are estimates at a given point in time of what the insurer expects to pay to claimants, based on facts and circumstances then known, and it can be expected that the ultimate liability will exceed or be less than such estimates. Liabilities are based on estimates of future trends and claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, additional facts regarding individual claims may become known, and consequently it often becomes necessary to refine and adjust the estimates of liability. Any adjustments are reflected in operating results in the period in which the changes in estimates are made.

DGI maintains liabilities for the eventual 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. The amount of liability for reported losses is primarily based upon a case-by-

case evaluation of the type of risk involved and knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amount of liability for unreported claims and loss expenses is determined on the basis of historical information by line of insurance. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Liabilities are closely monitored and are recomputed periodically by the Company and the Mutual Company using new information on reported claims and a variety of statistical techniques. Liabilities for losses are not discounted.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed DGI's loss and loss expense reserves and have an adverse effect on DGI's results of operations and financial condition. As is the case for virtually all property and casualty insurance companies, DGI has found it necessary in the past to revise estimated future liabilities for losses and loss expenses, and further adjustments could be required in the future. However, on the basis of DGI's internal procedures, which analyze, among other things, DGI's 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, management of DGI believes that adequate provision has been made for DGI's liability for losses and loss expenses.

Differences between liabilities reported in DGI's financial statements prepared on the basis of GAAP and financial statements prepared on a statutory accounting basis result from reducing statutory liabilities for anticipated salvage and subrogation recoveries. These differences amounted to \$8,197,948, \$8,042,860 and \$7,736,942 at December 31, 2001, 2000 and 1999, respectively.

The following tables set forth a reconciliation of the beginning and ending net liability for unpaid losses and loss expenses for the periods indicated on a GAAP basis for the Company.

	Year Ended December 31,		
	2001	2000	1999
	(in thousands)		
Gross liability for unpaid losses and loss expenses at beginning of year .....	\$156,476	\$144,180	\$136,727
Less reinsurance recoverable .....	53,767	44,946	40,712
Net liability for unpaid losses and loss expenses at beginning of year .....	102,709	99,234	96,015
Provision for net losses and loss expenses for claims incurred in the current year .....	110,143	103,671	100,573
Change in provision for estimated net losses and loss expenses for claims incurred in prior years .....	8,035	712	(493)
Total incurred .....	118,178	104,383	100,080

	Year Ended December 31,		
	2001	2000	1999
	(in thousands)		
Net losses and loss payments for claims incurred during:			
The current year .....	63,290	61,848	59,434
Prior years .....	43,053	39,060	37,427
Total paid .....	106,343	100,908	96,861
Net liability for unpaid losses and loss expenses at end of year .....	114,544	102,709	99,234
Plus reinsurance recoverable .....	65,296	53,767	44,946
Gross liability for unpaid losses and loss expenses at end of year .....	<u>\$179,840</u>	<u>\$156,476</u>	<u>\$144,180</u>

The following table sets forth the development of the liability for net unpaid losses and loss expenses for DGI on a GAAP basis from 1991 to 2001, with supplemental loss data for 2000 and 2001. Loss data in the table includes business assumed from the Mutual Company as part of the pooling arrangement.

"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 "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 is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1992 liability has developed an excess after nine years, in that reestimated net losses and loss expenses are expected to be \$7.8 million less than the estimated liability initially established in 1992 of \$44.3 million.

The "Cumulative excess" shows the cumulative excess at December 31, 2001 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 were reevaluated at less than the original amount. A deficiency in liability would mean that the liability established in prior years was less than actual net losses and loss expenses or were reevaluated at more than the original amount.

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 1992 column indicates that as of

December 31, 2001 payments equal to \$37.0 million of the currently reestimated ultimate liability for net losses and loss expenses of \$36.5 million had been made.

During the past several years, the Company has experienced a period during which redundancies in its loss and loss expense reserves have declined. In the most recent two years, the Company has experienced deficiencies in these reserves. These deficiencies were primarily related to the workers' compensation and commercial automobile lines of business. During 2001, the Company addressed the deficiencies in these two lines of business by strengthening both case basis and bulk reserves.



	Year Ended December 31				
	1991	1992	1993	1994	1995
	(in thousands)				
Net liability at end of year for unpaid losses and loss expenses .....	\$36,194	\$44,339	\$52,790	\$63,317	\$75,372
Net liability reestimated as of:					
One year later .....	37,514	45,408	50,583	60,227	72,380
Two years later .....	37,765	42,752	48,132	56,656	70,451
Three years later .....	35,446	40,693	44,956	54,571	66,936
Four years later .....	33,931	38,375	42,157	51,825	64,356
Five years later .....	32,907	37,096	41,050	50,493	63,095
Six years later .....	32,234	36,682	40,572	49,593	62,323
Seven years later .....	31,976	36,730	39,991	49,504	
Eight years later .....	31,685	36,437	40,113		
Nine years later .....	31,543	36,515			
Ten years later .....	31,549				
Cumulative (excess) deficiency .....	\$(4,645)	\$(7,824)	\$(12,677)	\$(13,813)	\$(13,049)
Cumulative amount of liability paid through:					
One year later .....	\$13,519	\$16,579	\$16,126	\$19,401	\$24,485
Two years later .....	20,942	24,546	25,393	30,354	37,981
Three years later .....	25,308	29,385	32,079	38,684	47,027
Four years later .....	27,826	32,925	36,726	43,655	53,276
Five years later .....	29,605	34,757	39,122	46,331	56,869
Six years later .....	30,719	35,739	40,440	47,802	58,286
Seven years later .....	31,173	36,518	40,903	48,520	
Eight years later .....	31,412	36,809	41,152		
Nine years later .....	31,585	37,000			
Ten years later .....	31,737				

[RESTUBBED]

	Year Ended December 31					
	1996	1997	1998	1999	2000	2001
	(in thousands)					
Net liability at end of year for unpaid losses and loss expenses .....	\$78,889	\$80,256	\$96,015	\$99,234	\$102,709	\$114,544
Net liability reestimated as of:						
One year later .....	77,400	77,459	95,556	100,076	110,744	
Two years later .....	73,438	76,613	95,315	103,943		
Three years later .....	71,816	74,851	94,830			
Four years later .....	69,378	73,456				
Five years later .....	69,485					
Six years later .....						
Seven years later .....						
Eight years later .....						
Nine years later .....						
Ten years later .....						
Cumulative (excess) deficiency .....	\$(9,404)	\$(6,800)	\$(1,185)	\$4,709	\$8,035	
Cumulative amount of liability paid through:						
One year later .....	\$27,229	\$27,803	\$37,427	\$39,060	\$43,053	
Two years later .....	41,532	46,954	57,347	60,622		
Three years later .....	53,555	58,883	69,973			
Four years later .....	59,995	65,898				
Five years later .....	63,048					
Six years later .....						
Seven years later .....						
Eight years later .....						
Nine years later .....						
Ten years later .....						

	Year Ended December 31							
	1994	1995	1996	1997	1998	1999	2000	2001
	(in thousands)							
Gross liability at end of year .....	\$88,484	\$108,118	\$113,346	\$115,801	\$136,727	\$144,180	\$156,476	\$179,840
Reinsurance recoverable .....	25,167	32,746	34,457	35,545	40,712	44,946	53,767	65,296

Net liability at end of year .....	63,317	75,372	78,889	80,256	96,015	99,234	102,709	114,544
Gross reestimated liability - latest...	65,646	84,074	101,365	106,188	129,473	153,953	166,312	
Reestimated recoverable - latest .....	16,142	21,751	31,880	32,732	34,643	50,010	55,568	
Net reestimated liability - latest ....	49,504	62,323	69,485	73,456	94,830	103,943	110,744	
Gross cumulative deficiency (excess)...	(22,838)	(24,044)	(11,981)	(9,613)	(7,254)	9,773	9,836	

## REINSURANCE

DGI and the Mutual Company use several different reinsurers, all of which have a Best rating of A- or better or, with respect to foreign reinsurers, have a financial condition which, in the opinion of management, is equivalent to a company with at least an A- rating.

The external reinsurance purchased by DGI and the Mutual Company includes "excess treaty reinsurance," under which losses are automatically reinsured over a set retention (\$300,000 for 2001), and "catastrophic reinsurance," under which the reinsured recovers 95% of an accumulation of many losses resulting from a single event, including natural disasters (for 2001, \$3,000,000 retention). DGI's principal reinsurance agreement in 2001, other than that with the Mutual Company, was an excess of loss treaty in which the reinsurers were Dorinco Reinsurance Company and Erie Insurance Group. Reinsurance is also purchased on an individual policy basis to reinsure losses that may occur from large risks, specific risk types or specific locations. 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. For property insurance, excess of loss treaties provide for coverage up to \$1,000,000. For liability insurance, excess of loss treaties provide for coverage up to \$30,000,000. Property catastrophe contracts provide coverage up to \$80,000,000 resulting from one event. On both property and casualty insurance, DGI and the Mutual Company purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their respective treaty reinsurance. Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 70% (65% prior to July 1, 2000) of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed and retained by the Mutual Company from Southern. Atlantic States, Southern, Pioneer Ohio and Southern Heritage each have a catastrophe reinsurance agreement with the Mutual Company that limits the maximum liability under any one catastrophic occurrence to \$400,000, \$300,000, \$200,000 and \$400,000, respectively, and \$1,000,000 for a catastrophe involving more than one of the companies. The Mutual Company and Pioneer Ohio are parties to an excess of loss reinsurance agreement in which the Mutual Company assumes up to \$250,000 of losses in excess of \$50,000. The Mutual Company and Southern are parties to an excess of loss reinsurance agreement in which the Mutual Company assumes up to \$50,000 of losses in excess of \$100,000 and a quota share agreement whereby Southern cedes 50% of its direct business less certain reinsurance to the Mutual Company. The Mutual Company and Southern Heritage are parties to an excess of loss reinsurance agreement in which the Mutual Company assumes up to \$175,000 of losses in excess of \$125,000. Southern, Pioneer Ohio and Southern Heritage each have agreements with the Mutual Company, under which they cede, and then reassume back, 100% of their business net of reinsurance. The purpose of the agreements is to provide these subsidiaries with the same A.M. Best rating (currently "A") as the Mutual Company, which these subsidiaries could not achieve without these agreements in place.

## COMPETITION

The property and casualty insurance industry is highly competitive on the basis of both price and service. There are numerous companies competing for this business in the geographic areas where the Company operates, many of which are substantially larger and have greater financial resources than DGI, and no single company dominates. In addition, because the insurance products of DGI and the Mutual Company are marketed exclusively through independent insurance agencies, most of which represent more than one company, DGI faces competition to retain qualified independent agencies, as well as competition within agencies.

## INVESTMENTS

DGI's return on invested assets is an important element of its financial results. Currently, the investment objective is to maintain a widely diversified fixed maturities portfolio structured to maximize after-tax investment income while minimizing credit risk through investments in high quality instruments. At December 31, 2001, all debt securities were rated investment grade with the exception of one unrated obligation of \$252,000, and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of the debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 2001:

Rating(1)	December 31, 2001	
	Amount	Percent
(dollars in thousands)		
U.S. Treasury and U.S. agency securities(2)	\$116,185	44.85%
Aaa or AAA	54,497	21.04
Aa or AA	46,480	17.94
A	41,267	15.93
BBB	361	.14
Not rated(3)	252	.10
<b>Total</b>	<b>\$259,042</b>	<b>100.00%</b>

- (1) Ratings assigned by Moody's Investors Services, Inc. or Standard & Poor's Corporation.
- (2) Includes mortgage-backed securities of \$23,400,708.
- (3) Represents one unrated obligation of The Lancaster County Hospital Authority Mennonite Home Project, which management of DGI believes to be equivalent to investment grade securities with respect to repayment risk.

DGI invests in both taxable and tax-exempt securities as part of its strategy to maximize after-tax income. Such strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 30.9%, 33.0% and 36.4% of the total investment portfolio at December 31, 2001, 2000 and 1999, respectively.

The following table shows the classification of the investments (at carrying value) of DGI and its subsidiaries at December 31, 2001, 2000 and 1999.

	December 31,					
	2001		2000		1999	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(dollars in thousands)					
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies .....	\$23,809	7.9%	\$38,779	13.4%	\$38,976	14.5%
Canadian government obligation .....	499	0.2	499	0.2	498	0.2
Obligations of states and political subdivisions .	24,982	8.3	66,831	23.1	67,824	25.3
Corporate securities ....	27,423	9.1	21,621	7.5	16,019	6.0
Mortgage-backed securities .....	8,610	2.9	15,452	5.3	16,322	6.1
Total held to maturity .....	85,323	28.4	143,182	49.5	139,639	52.1
Available for sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies .....	68,975	23.0	67,901	23.5	62,444	23.3
Obligations of states and political subdivisions .	55,147	18.3	18,256	6.3	20,408	7.6
Corporate securities ....	34,807	11.6	22,908	7.9	15,247	5.7
Mortgage-backed securities .....	14,790	4.9	5,546	1.9	4,401	1.6
Total available for sale .....	173,719	57.8	114,611	39.6	102,500	38.2
Total fixed maturities .....	259,042	86.2	257,793	89.1	242,139	90.3
Equity securities(2) ....	17,517	5.8	12,112	4.2	9,283	3.5
Short-term investments(3) .....	24,074	8.0	19,440	6.7	16,589	6.2
Total investments .....	\$300,633	100.0%	\$289,345	100.0%	\$268,011	100.0%

- (1) The Company accounts for its 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 3 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities held to maturity are valued at amortized cost; those fixed maturities available for sale are valued at fair value. Total fair value of fixed maturities held to maturity was \$86,939,393 at December 31, 2001, \$144,662,436 at December 31, 2000 and \$137,361,494 at December 31, 1999. The amortized cost of fixed maturities available for sale was \$170,269,584 at December 31, 2001, \$114,524,472 at December 31, 2000 and \$105,955,784 at December 31, 1999.
- (2) Equity securities are valued at fair value. Total cost of equity securities was \$16,630,618 at December 31, 2001, \$12,500,558 at December 31, 2000 and \$9,067,428 at December 31, 1999.
- (3) Short-term investments are valued at cost, which approximates market.

The following table sets forth the maturities (at carrying value) in the fixed maturity and short-term investment portfolio at December 31, 2001, December 31, 2000 and December 31, 1999.

	December 31,					
	2001		2000		1999	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	-----	-----	-----	-----	-----	-----
	(dollars in thousands)					
Due in(1):						
One year or less.....	\$37,120	13.1%	\$37,731	13.6%	\$35,606	13.8%
Over one year						
through three years.....	44,845	15.8	35,426	12.8	28,201	10.9
Over three years						
through five years.....	69,585	24.6	41,995	15.1	31,882	12.3
Over five years						
through ten years.....	96,642	34.1	112,396	40.6	105,533	40.8
Over ten years						
through fifteen years	7,573	2.7	22,243	8.0	30,658	11.8
Over fifteen years.....	3,950	1.4	6,445	2.3	6,125	2.4
Mortgage-backed securities.....	23,401	8.3	20,997	7.6	20,723	8.0
	-----	-----	-----	-----	-----	-----
	\$283,116	100.0%	\$277,233	100.0%	\$258,728	100.0%
	=====	=====	=====	=====	=====	=====

- (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, the Company held investments in mortgage-backed securities having a carrying value of \$23.4 million at December 31, 2001. Included in these investments are collateralized mortgage obligations ("CMOs") with a carrying value of \$7.5 million at December 31, 2001. The Company has attempted to reduce the prepayment risks associated with mortgage-backed securities by investing approximately 99.9%, as of December 31, 2001, of the Company's holdings of CMOs in planned amortization and very accurately defined tranches. Such investments are designed to alleviate the risk of prepayment by providing predictable principal prepayment schedules within a designated range of prepayments. If principal is repaid earlier than originally anticipated, investment yields may decrease due to reinvestment of the proceeds at current interest rates (which may be lower) and capital gains or losses may be realized since the book value of securities purchased at premiums or discounts may be different from the prepayment amount.

Investment results of DGI and its subsidiaries for the years ended December 31, 2001, 2000 and 1999 are shown in the following table:

	Year Ended December 31,		
	2001	2000	1999
	----	----	----
	(dollars in thousands)		
Invested assets(1).....	\$294,989	\$278,678	\$264,759
Investment income(2).....	15,886	16,395	13,591
Average yield.....	5.3%	5.9%	5.1%

- (1) Average of the aggregate invested amounts at the beginning and end of the period, including cash.

- (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

Currently, the A.M. Best rating of the Mutual Company, Atlantic States, Southern, Pioneer Ohio and Southern Heritage is "A", based upon their respective current financial conditions and historical statutory results of operations. Management believes that this Best rating is an important factor in marketing DGI's products to its agents and customers. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies as determined by their publicly available reports. 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). Best's ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. According to Best, an "excellent" rating is assigned to those companies which, in Best's opinion, have achieved excellent overall performance when compared to the norms of the property and casualty insurance industry and have generally demonstrated a strong ability to meet policyholder and other contractual obligations.

#### 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 to do business of insurers and agents, the nature of and limitations on investments, premium rates for property and casualty insurance, the provisions which 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, which augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 2001, DGI's insurance subsidiaries and the Mutual Company each exceeded the required levels of capital. There can be no assurance that the capital requirements applicable to DGI's insurance subsidiaries will not increase in the future.

The states in which Atlantic States (Pennsylvania, Maryland, Delaware, Connecticut and New York), the Mutual Company (Pennsylvania, Ohio, Maryland, New York, Virginia, Delaware and North Carolina), Southern (Virginia and Pennsylvania), Pioneer Ohio (Ohio and Pennsylvania) and Southern Heritage (Alabama, Arkansas, Georgia, Illinois, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee and Virginia) are licensed to do business have guaranty fund laws under which insurers doing business in such states 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. The Mutual Company, Atlantic States, Southern, Pioneer Ohio and Southern Heritage have made

accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During 2001, 2000 and 1999, the Company incurred assessments totaling \$1,286,578, \$813,000 and \$726,000, respectively, from the Pennsylvania Insurance Guaranty Association relating to the insolvencies of two medical malpractice insurers and Reliance Insurance Company.

Most states have enacted legislation that regulates insurance holding company systems. Each insurance company in the 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 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 the Mutual Company, the Company and the Company's insurance subsidiaries at any time, require disclosure of material transactions by the holding company and require prior notice or prior approval of certain transactions, such as "extraordinary dividends" from the insurance subsidiaries to the holding company.

All transactions within the holding company system affecting the Mutual Company and the Company's insurance subsidiaries must be fair and equitable. Approval of the applicable insurance commissioner is required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company is presumed to be a change in control. Pursuant to an order issued in July 2001, the Pennsylvania Insurance Department has approved the Mutual Company's ownership of up to 65% of the outstanding Class A Common Stock and up to 100% of the outstanding Class B Common Stock of DGI. These laws also require notice to the applicable insurance commissioner of certain material transactions between an insurer and any person in its holding company system and, in some states, certain of such transactions cannot be consummated without the prior approval of the applicable insurance commissioner.

The Company's insurance subsidiaries are restricted by the insurance laws of their respective states of domicile as to the amount of dividends or other distributions they may pay to the Company without the prior approval of the respective state regulatory authorities. Generally, the maximum amount that may be paid by an insurance subsidiary 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 a certain date, or the net income or net investment income not including realized capital gains of the subsidiary for the preceding year. As of December 31, 2001, amounts available for payment of dividends in 2001 without the prior approval of the various insurance commissioners were \$8,612,490 from Atlantic States, \$1,086,348 from Southern, \$552,447 from Pioneer Ohio and \$3,514,487 from Southern Heritage. See Note 12 to the Consolidated Financial Statements incorporated by reference herein.

The NAIC has adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codified principles are intended to provide a basis of

accounting recognized and adhered to in the absence of conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the statutory capital and surplus of the Company's insurance subsidiaries as of January 1, 2001 is as follows: Atlantic States - \$6,168,742 increase; Southern Heritage - \$1,083,354 increase; Pioneer Ohio - \$313,638 increase; and Southern - \$1,171,204 increase.

#### THE MUTUAL COMPANY

The Mutual Company, which was organized in 1889, has a Best rating of A (Excellent). At December 31, 2001, the Mutual Company had admitted assets of \$179,847,955 and policyholders' surplus of \$72,447,287. At December 31, 2001, the Mutual Company had no debt and, of its total liabilities of \$107,400,668, reserves for net losses and loss expenses accounted for \$53,372,948 and unearned premiums accounted for \$27,296,097. Of the Mutual Company's investment portfolio of \$107,762,981 at December 31, 2001, investment-grade bonds accounted for \$31,924,796 and mortgages accounted for \$7,924,146. At December 31, 2001, the Mutual Company owned 3,833,089 shares, or 63.7%, of the Company's Class A Common Stock, which were carried on the Mutual Company's books at \$39,825,804, and 1,852,088 shares, or 62.1%, of the Company's Class B Common Stock, which were carried on the Mutual Company's books at \$19,243,194. The foregoing financial information is presented on the statutory basis of accounting.

#### EMPLOYEES

The Company has no employees. As of December 31, 2001, the Mutual Company had 437 employees. The Mutual Company's employees provide a variety of services to DGI, Atlantic States, Southern, Southern Heritage and Pioneer Ohio, as well as to the Mutual Company.

#### CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

Certain statements contained in or incorporated by reference in this Report are forward-looking in nature. These statements can be identified by the use of forward-looking words such as "believes," "expects," "may," "will," "should," "intends," "plans" or "anticipates," or the negative thereof or comparable terminology, or by discussions of strategy. The Company's business and operations are subject to a variety of risks and uncertainties and, consequently, the Company's actual results may materially differ from those projected by any forward-looking statements. Certain of these risks and uncertainties are discussed below under "Risk Factors."

## RISK FACTORS

THE CYCLICAL NATURE OF THE PROPERTY AND CASUALTY INSURANCE INDUSTRY MAY REDUCE THE COMPANY'S REVENUES AND PROFIT MARGINS.

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

Volatile and unpredictable developments also offset significantly the cyclical trends in the industry and the industry's profitability. These developments include natural disasters (such as storms, earthquakes, hurricanes, floods and fires), fluctuations in interest rates and other changes in the investment environment that affect the market prices of the Company's investments and the income from those investments, inflationary pressures that affect the size of losses and judicial decisions that affect its liabilities. The occurrence of these developments may adversely affect the Company's business and financial condition.

THE NATURE OF THE INSURANCE INDUSTRY LIMITS THE COMPANY'S ABILITY TO CHANGE PRICES TO REFLECT RISKS AND TO ESTIMATE THE COMPANY'S RESERVES ACCURATELY.

One of the distinguishing features of the property and casualty industry is that its products generally are priced before its costs are known. The Company's products are priced in this manner because premium rates usually are determined at the time the policy is issued and before losses are reported. Changes in statutory and case law can also dramatically affect the liabilities associated with known risks after the insurance policy is issued. The number of competitors and the similarity of products offered, as well as regulatory constraints, limit the Company's ability to increase prices in response to declines in profitability. The Company's reported profits and losses are also determined, in part, by the establishment and adjustment of reserves reflecting estimates made by management as to the amount of losses and loss adjustment expenses that will ultimately be incurred in the settlement of claims. The Company's ultimate liability for all losses and loss adjustment expenses reserved at any given time will likely be greater or less than these estimates, and material shortfalls in the estimates may have a material adverse effect on the Company in future periods.

THE COMPANY COMPETES WITH MANY INSURERS THAT ARE FINANCIALLY STRONGER THAN THE COMPANY.

The property and casualty insurance industry is intensely competitive. Competition is based on many factors, including the perceived financial strength of the insurer, premiums charged, policy terms and conditions, policyholder service, reputation and experience. The Company competes 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 the Company, have substantially greater financial, technical and operating resources and have equal or higher ratings from A.M. Best Company.

The superior capitalization of many of the Company's competitors enables them to withstand lower profit margins and, therefore, to market their products more aggressively, to take advantage more quickly of new marketing opportunities and offer lower premium rates. Moreover, if the Company's competitors price their premiums more aggressively and the Company meets their pricing, the Company's profit margins and revenues may be reduced and its ratios of claims and expenses to premiums may increase.

The Company's competition may become increasingly better capitalized in the future as the traditional barriers between insurance companies and banks and other financial institutions erode and as the property and casualty industry continues to consolidate. The Company's ability to compete against its larger, better capitalized competitors depends largely on its ability to provide superior policyholder service and to maintain its historically strong relationships with independent insurance agents, on whom the Company is entirely dependent to generate premium volume.

There is no assurance that the Company will maintain its current competitive position in the markets in which it operates, or that it will be able to expand its operations into new markets. If it fails to do so, its business could be materially adversely affected.

THE COMPANY IS A REGIONAL INSURANCE COMPANY THAT OFFERS INSURANCE PRODUCTS IN A LIMITED NUMBER OF STATES.

The Company is headquartered in Pennsylvania and engages in the insurance business in approximately 14 Middle Atlantic and Southern states. In 2001, the majority of the Company's direct premiums written, including those of the Mutual Company and DGI's insurance subsidiaries, were geographically dispersed as follows: 63.0% in Pennsylvania, 14.3% in Virginia and 5.9% in Maryland. Any single catastrophic occurrence, destructive weather pattern, general economic trend or other condition disproportionately affecting losses or business conditions in these states could adversely affect the Company's results of operations, although the Company and the Mutual Company maintain reinsurance against catastrophic losses in excess of \$3,000,000 per occurrence and the Company's insurance subsidiaries maintain various catastrophe reinsurance agreements with the Mutual Company that limit the maximum liability under any one catastrophe.

THE REINSURANCE AGREEMENTS ON WHICH THE COMPANY RELIES DO NOT RELIEVE THE COMPANY FROM LIABILITY TO ITS POLICYHOLDERS.

The Company relies on reinsurance agreements to limit its maximum net loss from large single risks or risks in concentrated areas, and to increase its capacity to write insurance. Each reinsurance agreement satisfies all applicable regulatory requirements. Reinsurance, however, does not relieve the Company from liability to its policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable under the terms of its reinsurance agreement with the Company, the Company remains liable for such losses. However, in an effort to reduce the risk of non-payment, the Company requires all of its 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 the Company's management, is equivalent to a company with at least an A rating. If the Company's reinsurers incur losses from their reinsurance arrangements with the Company, it is probable that the reinsurance premiums payable by the Company in the future could increase.

THE COMPANY IS SUBJECT TO EXTENSIVE STATE INSURANCE REGULATION.

The Company is subject to the laws and regulations of the states in which it conducts business. These laws and regulations address many aspects of the Company's business and financial condition, including licensure, the payment of dividends, the establishment of premium rates, the settlement of claims, the transfer of control and the requirement that the Company participate in assigned risk pools. Certain of the following laws and regulations could have a material adverse effect on the Company's results of operations:

- 0 state insurance regulations that require the Company to file proposed premium rates in advance of premium rate increases;
- 0 state insurance regulations that mandate required levels of statutory surplus;
- 0 private rating organization review of the Company's levels of statutory surplus and claims-paying ability; and
- 0 NAIC and state insurance department review of the Company's risk-based capital levels.

Changes in the level of regulation of the insurance industry and laws or regulations themselves or interpretations by regulatory authorities could also have a material adverse effect on the Company's operations. Specific regulatory developments that could have a material adverse effect on the Company's operations include the potential repeal of the McCarran-Ferguson Act, which exempts insurance companies from a variety of federal regulatory requirements, possible rate rollback regulation and legislation to control premiums, policy terminations and other policy terms.

THE MUTUAL COMPANY IS THE COMPANY'S LARGEST SHAREHOLDER AND PROVIDES IT WITH FACILITIES AND SERVICES.

The Mutual Company currently owns approximately 63.7% of the Company's outstanding Class A Common Stock and 62.1% of the Company's outstanding Class B Common Stock. Accordingly, the Mutual Company controls the election of members of the Company's Board of Directors. Although the Mutual Company could exercise its control in ways that are contrary to the interests of the Company's stockholders other than the Mutual Company, the Company and the Mutual Company have established a Coordinating Committee consisting of two outside directors from each company who do not also serve as directors of the other company. Under the Company's and the Mutual Company's By-laws, any new agreement between the Company and the Mutual Company and any proposed change in any existing agreement between the Company and the Mutual Company must first be submitted for approval by the respective Boards of Directors of the Company and the Mutual Company and, if approved, submitted to the Coordinating Committee for approval. The proposed new agreement or change in an existing agreement will receive Coordinating Committee approval only if both of the Company's Coordinating Committee members conclude the new agreement or change in an existing agreement is fair to the Company and its stockholders and if both of the Mutual Company's members conclude the agreement is fair and equitable to the Mutual Company and its policyholders. The decisions of the Coordinating Committee are binding on the Company and the Mutual Company. The purpose of this provision is to protect the interests of the stockholders of the Company and the interests of the policyholders of the Mutual Company.

The Company is dependent upon the Mutual Company for the retention of agents and the underwriting of insurance, the servicing of policyholder claims and all other aspects of the Company's operations. All of the Company's officers are officers and employees of the Mutual Company. The Mutual Company also provides all of the facilities and data processing and administrative services required to conduct the Company's business, for which the Company pays a pro rata portion of the cost.

BECAUSE THE COMPANY PARTICIPATES IN AN INSURANCE POOLING ARRANGEMENT WITH THE MUTUAL COMPANY, THE COMPANY'S RESULTS OF OPERATIONS ARE DEPENDENT UPON THE FINANCIAL SUCCESS OF THE MUTUAL COMPANY.

The Company's insurance subsidiary, Atlantic States, participates in an intercompany pooling arrangement with the Mutual Company, under which the parties share the premiums earned and underwriting results on substantially all of the property and casualty insurance business written by both companies. Under the terms of the intercompany pooling agreement, Atlantic States cedes all of its insurance business to the Mutual Company and assumes from the Mutual Company 70% of the total pooled insurance business of the Mutual Company and Atlantic States. The allocations of pool participation percentages between the Mutual Company and Atlantic States are based on the pool participants' relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and the Company's ability to raise capital for Atlantic States.

Because of the pooled business the Company assumes, the Company's insurance operations are interrelated with the insurance operations of the Mutual Company and the Company's results of operations are dependent upon the financial success of the Mutual Company. Although the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for the participants in the pool than they would experience individually and to spread the risk of loss among all the participants, if the Mutual Company experiences unusually severe or frequent losses or does not adequately price its premiums, the Company's results of operations could suffer. The Company's results of operations also may suffer if the Mutual Company did not participate in the pooling arrangement because the pool participants would then be limited to policy exposures of a size commensurate with their own capital and surplus instead of having at their disposal the capacity of the entire pool.

THE COMPANY'S BUSINESS DEPENDS IN PART ON THE MARKETING EFFORTS OF INDEPENDENT INSURANCE AGENTS, AND IT IS POSSIBLE THAT THESE AGENTS MAY NOT MARKET THE COMPANY'S PRODUCTS SUCCESSFULLY OR SELL THE COMPANY'S PRODUCTS WITHIN THE GUIDELINES THE COMPANY SPECIFIES.

The Company markets and sells almost all of its insurance products through independent, non-exclusive insurance agents. These agents are not obligated to promote the Company's insurance products exclusively and they also sell competitors' insurance products. The Company's business depends in part on the marketing efforts of these agents, and the Company's must offer insurance products and services that meet the requirements of these independent agencies. If these agencies do not market the Company's products successfully or give priority to other insurers, the Company's business may be adversely impacted.

The Company also grants certain agents the authority to bind insurance without the Company's prior approval within underwriting and pricing limits that the Company specifies. However, the Company generally reviews all coverages placed by its agents and may cancel the coverage if it is inconsistent with the Company's guidelines and permissible to cancel under applicable insurance regulations. If the Company is unable to cancel the coverage placed by an agent prior to a claim being placed by the insured, the Company's risk may be increased and its profitability may suffer.

THE COMPANY'S ESTABLISHED RESERVES FOR LOSSES AND LOSS ADJUSTMENT EXPENSES ARE BASED ON ESTIMATES, AND IT IS POSSIBLE THAT THE COMPANY'S ULTIMATE LIABILITY WILL EXCEED THESE ESTIMATES.

The Company establishes reserves for losses and loss adjustment expenses based on estimates of amounts needed to pay reported and unreported claims and related loss adjustment expenses. These estimates are based on facts and circumstances then known to the Company. Reserves are based on estimates of future trends and claims severity, judicial theories of liability and other factors.



The establishment of appropriate reserves is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed the Company's loss and loss adjustment expense reserves and have an adverse effect on the Company's results of operations and financial condition. As is the case for most property and casualty insurance companies, the Company has found it necessary in the past to revise estimated liabilities as reflected in the Company's loss and loss adjustment expense reserves, and further adjustments could be required in the future. However, the Company's management believes that adequate provision has been made for the Company's loss and loss adjustment expense reserves. This belief is based on the Company's internal procedures, which analyze the Company's 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.

THE COMPANY IS DEPENDENT ON DIVIDENDS FROM ITS SUBSIDIARIES FOR THE PAYMENT OF ITS OPERATING EXPENSES, ITS DEBT SERVICE AND DIVIDENDS TO STOCKHOLDERS.

As a holding company, the Company relies primarily on its subsidiaries for dividends and other permitted payments to meet its obligations for corporate expenses. Payment of dividends by the Company's subsidiaries is subject to regulatory restrictions and depends on the surplus of the subsidiaries. From time to time, the NAIC and various state insurance regulators consider modifying the method of determining the amount of dividends that may be paid by an insurance company without prior regulatory approval.

Item 2. Properties.

DGI and Atlantic States share headquarters with the Mutual Company's headquarters in a building owned by the Mutual Company. The Mutual Company charges DGI for an appropriate portion of the building expenses under an intercompany allocation agreement which is consistent with the terms of the pooling agreement. The headquarters of the Mutual Company has approximately 163,500 square feet of office space. Southern has a facility of approximately 10,000 square feet in Glen Allen, Virginia, which it owns. Pioneer Ohio has a facility of approximately 10,000 square feet in Greenville, Ohio, which it owns. Southern Heritage has a facility of approximately 14,000 square feet in Duluth, Georgia, which it leases. Atlantic States has a facility of approximately 6,200 square feet in Greenville, New York, which it owns. Province Bank leases approximately 3,600 square feet of a building located in Marietta, Pennsylvania owned by the Mutual Company. The Mutual Company charges Province Bank annual rent based on an independent appraisal.

Item 3. Legal Proceedings.

DGI is a party to numerous lawsuits arising in the ordinary course of its insurance business. DGI believes that the resolution of these lawsuits will not have a material adverse effect on its financial condition or results of operations.

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

No matter was submitted to a vote of holders of the Company's Class A Common Stock and/or Class B Common Stock during the fourth quarter of 2001.

Executive Officers of the Company

The following table sets forth information regarding the persons who served as executive officers of DGI on March 15, 2002:

Name	Age	Position
Donald H. Nikolaus	59	President and Chief Executive Officer since 1981
Ralph G. Spontak	49	Senior Vice President since 1991; Chief Financial Officer and Vice President since 1983; Secretary since 1988
Cyril J. Greenya	57	Senior Vice President - Commercial Underwriting since 1997; Vice President - Commercial Underwriting for five years prior thereto; Manager - Commercial Underwriting for nine years prior thereto
Robert G. Shenk	49	Senior Vice President - Claims since 1997; Vice President - Claims for five years prior thereto
Daniel J. Wagner	41	Treasurer since 1993; Controller for five years prior thereto

PART II

Item 5. Market for the Registrant's Common Equity and Related

-----  
Stockholder Matters.  
-----

The response to this Item is incorporated in part by reference to page 32 of the Company's Annual Report to Stockholders for the year ended December 31, 2001, which is included as Exhibit (13) to this Form 10-K Report. As of March 15, 2002, the Company had approximately 586 holders of record of its Class A Common Stock and 532 holders of record of its Class B Common Stock. The Company declared dividends of \$.40 per share on its Class A Common Stock and \$.36 per share on its Class B Common Stock in 2001 and \$.36 per share on its Common Stock in 2000.

Item 6. Selected Financial Data.  
-----

The response to this Item is incorporated by reference to page 1 of the Company's Annual Report to Stockholders for the year ended December 31, 2001, which is included as Exhibit (13) to this Form 10-K Report.

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

-----  
and Result of Operations.  
-----

The response to this Item is incorporated by reference to pages 10 through 14 of the Company's Annual Report to Stockholders for the year ended December 31, 2001, which is included as Exhibit (13) to this Form 10-K Report.

Item 8. Financial Statements and Supplementary Data.  
-----

The response to this Item is incorporated by reference to pages 15 through 31 of the Company's Annual Report to Stockholders for the year ended December 31, 2001, which is included as Exhibit (13) to this Form 10-K Report.

Item 9. Changes in and Disagreements with Accountants on

-----  
Accounting and Financial Disclosure.  
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None.

PART III

Item 10. Directors and Executive Officers of the Registrant.  
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The response to this Item with respect to the Company's directors is incorporated by reference to pages 7 through 10 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 18, 2002. The response to this Item with respect to the Company's executive officers is incorporated by reference to Part I of this Form 10-K Report.

Item 11. Executive Compensation.  
-----

The response to this Item is incorporated by reference to pages 9 through 12 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 18, 2002, except for the Report of Compensation Committee, the Performance Graph and the Report of the Audit Committee, which are not incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners  
-----  
and Management.  
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The response to this Item is incorporated by reference to pages 3 through 4 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 18, 2002.

Item 13. Certain Relationships and Related Transactions.  
-----

The response to this Item is incorporated by reference to pages 3 through 9 and page 15 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 18, 2002.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports

on Form 8-K.

- (a) Financial statements, financial statement schedules and exhibits filed:
- (1) Consolidated Financial Statements

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	----
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- (2) Financial Statement Schedules

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Donegal Group Inc. and Subsidiaries	
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All other schedules have been omitted since they are not required, not applicable or the information is included in the financial statements or notes thereto.

\* Refers to the respective page of Donegal Group Inc.'s 2001 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial

Statements and Auditor's Report thereon on pages 15 through 31 are incorporated herein by reference. With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8 hereof, such Annual Report shall not be deemed filed as part of this Form 10-K Report or otherwise subject to the liabilities of Section 18 of the Securities Exchange Act of 1934.

(3) Exhibits

Exhibit No. -----	Description of Exhibits -----	Reference -----
(3)(i)	Certificate of Incorporation of Registrant, as amended	(a)
(3)(ii)	Amended and Restated By-laws of Registrant	Filed herewith
Management Contracts and Compensatory Plans or Arrangements -----		
(10)(A)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan	(b)
(10)(B)	Donegal Group Inc. 2001 Equity Incentive Plan for Employees	(c)
(10)(C)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan for Directors	(d)
(10)(D)	Donegal Group Inc. 2001 Equity Incentive Plan for Directors	(c)
(10)(E)	Donegal Group Inc. 2001 Employee Stock Purchase Plan, as amended	(e)
(10)(F)	Donegal Group Inc. Amended and Restated 2001 Agency Stock Purchase Plan	(f)
(10)(G)	Donegal Mutual Insurance Company 401(k) Plan	(g)
(10)(H)	Amendment No. 1 effective January 1, 2000 to Donegal Mutual Insurance Company 401(k) Plan	(g)
(10)(I)	Amendment No. 2 effective January 6, 2000 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(J)	Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith

Exhibit No. -----	Description of Exhibits -----	Reference -----
(10)(K)	Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(L)	Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(M)	Donegal Mutual Insurance Company Executive Restoration Plan	(h)
Other Material Contracts -----		
(10)(N)	Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company	(i)
(10)(O)	Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company	(i)
(10)(P)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(i)
(10)(Q)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(j)
(10)(R)	Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance	(k)
(10)(S)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(l)
(10)(T)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(m)

Exhibit No. -----	Description of Exhibits -----	Reference -----
(10)(U)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(h)
(10)(V)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia	(h)
(10)(W)	Reinsurance and Retrocession Agreement effective January 1, 2000 between Donegal Mutual Insurance Company and Southern Heritage Insurance Company	(g)
(10)(X)	Property and Catastrophe Excess of Loss Reinsurance Agreement effective January 1, 2000 between Donegal Mutual Insurance Company and Southern Heritage Insurance Company	(g)
(10)(Y)	Amended and Restated Credit Agreement dated as of July 27, 1998 among Donegal Group Inc., the banks and other financial institutions from time to time party thereto and Fleet National Bank, as agent	(n)
(10)(Z)	First Amendment and Waiver to the Amended and Restated Credit Agreement dated as of December 31, 1999	(g)
(10)(AA)	Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(o)
(10)(BB)	Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB	(c)
(10)(CC)	Aggregate Excess of Loss Reinsurance Agreement dated as of January 1, 2001 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(c)
(13)	2001 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report)	Filed herewith



Exhibit No. -----	Description of Exhibits -----	Reference -----
(20)	Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 18, 2002, provided, however, that the Report of the Compensation Committee, the Performance Graph and the Report of the Audit Committee shall not be deemed filed as part of this Form 10-K Report	(p)
(21)	Subsidiaries of Registrant	Filed herewith
(23)	Consent of Independent Auditors	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, 1998.
  - (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 10-K Report for the year ended December 31, 1997.
  - (e) 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.
  - (f) 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.
  - (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, 1999.
  - (h) 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.

- (i) 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.
- (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, 1988.
- (k) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 33-67346 declared effective September 29, 1993.
- (l) 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.
- (m) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.
- (n) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated November 17, 1998.
- (o) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated May 31, 2000.
- (p) Such exhibit is hereby incorporated by reference to the Registrant's definitive proxy statement filed March 22, 2002.

(b) Reports on Form 8-K:

None.

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE I - SUMMARY OF INVESTMENTS  
OTHER THAN INVESTMENTS IN RELATED PARTIES

-----  
(\$ in thousands)

December 31, 2001

	Cost	Fair Value	Amount at Which Shown in the Balance Sheet
	-----	-----	-----
Fixed Maturities:			
Held to maturity:			
United States government and Governmental agencies and authorities including obligations of states and political subdivisions	\$ 48,791	\$ 49,736	\$ 48,791
Canadian government obligation	499	535	499
All other corporate bonds	27,423	27,962	27,423
Mortgage-backed securities	8,610	8,706	8,610
	-----	-----	-----
Total fixed maturities held to maturity	85,323	86,939	85,323
	-----	-----	-----
Available for sale:			
United States government and Governmental agencies and authorities including obligations of states and political subdivisions	121,432	124,122	124,122
All other corporate bonds	34,094	34,807	34,807
Mortgage-backed securities	14,744	14,790	14,790
	-----	-----	-----
Total fixed maturities available for sale	170,270	173,719	173,719
	-----	-----	-----
Total fixed maturities	255,593	260,658	259,042
	-----	-----	-----
Equity Securities:			
Preferred stocks			
Public utilities	227	256	256
Banks	7,201	7,222	7,222
Industrial and miscellaneous	1,677	1,722	1,722
	-----	-----	-----
Total preferred stocks	9,105	9,200	9,200
	-----	-----	-----
Common stocks			
Banks and insurance companies	3,978	4,822	4,822
Industrial and miscellaneous	3,548	3,495	3,495
	-----	-----	-----
Total common stocks	7,526	8,317	8,317
	-----	-----	-----
Total equity securities	16,631	17,517	17,517
	-----	-----	-----
Short-term investments	24,074	24,074	24,074
	-----	-----	-----
Total investments	\$296,298	\$302,249	\$300,633
	=====	=====	=====

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Balance Sheets  
(\$ in thousands)

December 31, 2001 and 2000

ASSETS

	2001	2000
	-----	-----
Investment in subsidiaries (equity method)	\$152,089	\$155,600
Cash	403	2,381
Property and equipment	1,623	1,997
Other	264	715
	-----	-----
Total assets	\$154,379	\$160,693
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

	2001	2000
	-----	-----
Cash dividends declared to stockholders	\$ 870	\$ 797
Line of credit	27,600	40,000
Due to affiliate	4,441	4,441
Other	540	1,325
	-----	-----
Total liabilities	33,451	46,563
	-----	-----
Stockholders' equity	120,928	114,130
	-----	-----
Total liabilities and stockholders' equity	\$154,379	\$160,693
	=====	=====

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

(Continued)  
Condensed Statements of Income  
(\$ in thousands)

Years ended December 31, 2001, 2000 and 1999

	2001	2000	1999
	-----	-----	-----
Revenues			
Dividends-subsiary	\$14,419	\$3,900	\$820
Other	824	866	865
	-----	-----	-----
Total revenues	15,243	4,766	1,685
Expenses			
Operating expenses	1,761	1,165	938
Interest	2,288	3,304	2,463
	-----	-----	-----
Total expenses	4,049	4,469	3,401
	-----	-----	-----
Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries	11,194	297	(1,716)
Income tax benefit	(1,067)	(1,226)	(807)
	-----	-----	-----
Income (loss) before equity in undistributed net income (loss) of subsidiaries	12,261	1,523	(909)
	-----	-----	-----
Equity in undistributed net income (loss) of subsidiaries	(6,443)	7,314	7,704
	-----	-----	-----
Net income	\$5,818	\$8,837	\$6,795
	=====	=====	=====

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED INFORMATION OF PARENT COMPANY

Condensed Statements of Cash Flows  
(\$ in thousands)

Years ended December 31, 2001, 2000 and 1999

	2001	2000	1999
	-----	-----	-----
Cash flows from operating activities:			
Net income	\$5,818	\$8,837	\$6,795
	-----	-----	-----
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Equity in undistributed net (income) loss of subsidiaries	6,443	(7,314)	(7,704)
Other	252	1,123	2,365
	-----	-----	-----
Net adjustments	6,695	(6,191)	(5,339)
	-----	-----	-----
Net cash provided by operating activities	12,513	2,646	1,456
	-----	-----	-----
Cash flows from investing activities:			
Net purchase of property and equipment	(122)	(262)	(426)
Sale of subsidiary	--	--	100
Investment in Donegal Financial	--	(3,042)	--
Other	38	38	(426)
	-----	-----	-----
Net cash used in investing activities	(84)	(3,266)	(752)
	-----	-----	-----
Cash flows from financing activities:			
Cash dividends paid	(3,394)	(3,127)	(2,946)
Issuance of common stock	1,387	2,757	2,514
Line of credit, net	(12,400)	3,000	(500)
	-----	-----	-----
Net cash provided by (used in) financing activities	(14,407)	2,630	(932)
	-----	-----	-----
Net change in cash	(1,978)	2,010	(228)
Cash beginning	2,381	371	599
	-----	-----	-----
Cash ending	\$403	\$2,381	\$371
	=====	=====	=====

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

(\$ in thousands)

Years Ended December 31, 2001, 2000 and 1999

Segment	Net Earned Premiums	Net Investment Income	Net Losses And Loss Expense	Amortization of Deferred Policy Acquisition Costs	Other Underwriting Expenses	Net Premiums Written
Year Ended December 31, 2001						
Personal lines	\$104,893	\$ ---	\$72,534	\$17,002	\$16,881	\$111,623
Commercial lines	62,877	---	45,644	10,192	10,119	65,405
Investments	---	15,886	---	---	---	---
	<u>\$167,770</u>	<u>\$15,886</u>	<u>\$118,178</u>	<u>\$27,194</u>	<u>\$27,000</u>	<u>\$177,028</u>
Year Ended December 31, 2000						
Personal lines	\$97,065	\$ ---	\$68,003	\$16,206	\$14,950	\$100,517
Commercial lines	54,581	---	36,380	9,113	8,406	59,605
Investments	---	16,395	---	---	---	---
	<u>\$151,646</u>	<u>\$16,395</u>	<u>\$104,383</u>	<u>\$25,319</u>	<u>\$23,356</u>	<u>\$160,122</u>
Year Ended December 31, 1999						
Personal lines	\$97,713	\$ ---	\$68,400	\$16,741	\$19,237	\$93,363
Commercial lines	47,804	---	31,681	8,190	9,412	50,509
Investments	---	13,591	---	---	---	---
	<u>\$145,517</u>	<u>\$13,591</u>	<u>\$100,081</u>	<u>\$24,931</u>	<u>\$28,649</u>	<u>\$143,872</u>

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION, CONTINUED

-----  
 (\$ in thousands)

	At December 31,			
Segment	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable
-----	-----	-----	-----	-----
2001				
----				
Personal lines	\$8,394	\$84,726	\$70,388	\$ --
Commercial lines	5,210	95,114	43,691	--
Investments	--	--	--	--
	-----	-----	-----	-----
	\$13,604	\$179,840	\$114,079	\$ --
	=====	=====	=====	=====
2000				
----				
Personal lines	\$6,759	\$77,546	\$54,992	\$ --
Commercial lines	5,525	78,930	44,948	--
Investments	--	--	--	--
	-----	-----	-----	-----
	\$12,284	\$156,476	\$99,940	\$ --
	=====	=====	=====	=====



DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE IV - REINSURANCE

	Gross Amount -----	Ceded To Other Companies -----	Assumed from Other Companies -----	Percentage Net Amount -----	Assumed To Net -----
Year Ended December 31, 2001 -----					
Property and casualty premiums	\$105,214,059 =====	\$61,249,516 =====	\$123,805,311 =====	\$167,769,854 =====	74% ==
Year Ended December 31, 2000 -----					
Property and casualty premiums	\$95,671,588 =====	\$52,375,211 =====	\$108,349,822 =====	\$151,646,199 =====	71% ==
Year Ended December 31, 1999 -----					
Property and casualty premiums	\$93,399,834 =====	\$46,837,108 =====	\$98,954,731 =====	\$145,517,457 =====	68% ==

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION  
 CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

	Deferred Policy Acquisition Costs -----	Liability For Losses And Loss Expenses -----	Discount, if any, Deducted From Reserves -----	Unearned Premiums -----
At December 31,				
2001	\$13,604,215 =====	\$179,839,905 =====	\$-- ===	\$114,079,264 =====
2000	\$12,284,214 =====	\$156,476,124 =====	\$-- ===	\$99,940,381 =====
1999	\$11,445,572 =====	\$144,180,006 =====	\$-- ===	\$88,307,928 =====

(continued)

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION  
 CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES, CONTINUED

Years ended December 31, 2001, 2000 and 1999

	Losses and Loss Expenses Related to				Amortization of Deferred Policy Acquisition Costs	Net Paid Losses And Loss Expenses	Net Premiums Written
	Net Earned Premiums	Investment Income	Current Year	Prior Years			
Year Ended December 31, 2001	\$167,769,854	\$15,885,544	\$110,142,467	\$8,035,082	\$27,194,000	\$106,342,848	\$177,027,654
Year Ended December 31, 2000	\$151,646,199	\$16,394,747	\$103,671,401	\$711,775	\$25,319,000	\$100,907,860	\$160,122,420
Year Ended December 31, 1999	\$145,517,457	\$13,590,695	\$100,573,192	\$(492,576)	\$24,931,000	\$96,861,295	\$143,872,389

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.

Date: March 28, 2002

By: /s/Donald H. Nikolaus

-----  
Donald H. Nikolaus, President

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.

Signature -----	Title -----	Date -----
/s/Donald H. Nikolaus ----- Donald H. Nikolaus	President and a Director (principal executive officer)	March 28, 2002
/s/Ralph G. Spontak ----- Ralph G. Spontak	Senior Vice President, Chief Financial Officer and Secretary (principal financial and accounting officer)	March 28, 2002
/s/Robert S. Bolinger ----- Robert S. Bolinger	Director	March 28, 2002
/s/Thomas J. Finley ----- Thomas J. Finley	Director	March 28, 2002
/s/Patricia A. Gilmartin ----- Patricia A. Gilmartin	Director	March 28, 2002
/s/Philip H. Glatfelter ----- Philip H. Glatfelter	Director	March 28, 2002
/s/John J. Lyons ----- John J. Lyons	Director	March 28, 2002
/s/C. Edwin Ireland ----- C. Edwin Ireland	Director	March 28, 2002
/s/R. Richard Sherbahn ----- R. Richard Sherbahn	Director	March 28, 2002

EXHIBIT INDEX

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(Pursuant to Item 601 of Regulation S-K)

Exhibit No. -----	Description of Exhibits -----	Reference -----
(3)(i)	Certificate of Incorporation of Registrant, as amended	(a)
(3)(ii)	Amended and Restated By-laws of Registrant	Filed herewith
	Management Contracts and Compensatory Plans or Arrangements -----	
(10)(A)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan	(b)
(10)(B)	Donegal Group Inc. 2001 Equity Incentive Plan for Employees	(c)
(10)(C)	Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan for Directors	(d)
(10)(D)	Donegal Group Inc. 2001 Equity Incentive Plan for Directors	(c)
(10)(E)	Donegal Group Inc. 2001 Employee Stock Purchase Plan, as amended	(e)
(10)(F)	Donegal Group Inc. Amended and Restated 2001 Agency Stock Purchase Plan	(f)
(10)(G)	Donegal Mutual Insurance Company 401(k) Plan	(g)
(10)(H)	Amendment No. 1 effective January 1, 2000 to Donegal Mutual Insurance Company 401(k) Plan	(g)
(10)(I)	Amendment No. 2 effective January 6, 2000 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(J)	Amendment No. 3 effective July 23, 2001 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(K)	Amendment No. 4 effective January 1, 2002 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith
(10)(L)	Amendment No. 5 effective December 31, 2001 to Donegal Mutual Insurance Company 401(k) Plan	Filed herewith

Exhibit No. -----	Description of Exhibits -----	Reference -----
(10)(M)	Donegal Mutual Insurance Company Executive Restoration Plan	(h)
	Other Material Contracts -----	
(10)(N)	Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company	(i)
(10)(O)	Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company	(i)
(10)(P)	Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(i)
(10)(Q)	Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(j)
(10)(R)	Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance	(k)
(10)(S)	Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(l)
(10)(T)	Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(m)
(10)(U)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(h)

Exhibit No. -----	Description of Exhibits -----	Reference -----
(10)(V)	Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia	(h)
(10)(W)	Reinsurance and Retrocession Agreement effective January 1, 2000 between Donegal Mutual Insurance Company and Southern Heritage Insurance Company	(g)
(10)(X)	Property and Catastrophe Excess of Loss Reinsurance Agreement effective January 1, 2000 between Donegal Mutual Insurance Company and Southern Heritage Insurance Company	(g)
(10)(Y)	Amended and Restated Credit Agreement dated as of July 27, 1998 among Donegal Group Inc., the banks and other financial institutions from time to time party thereto and Fleet National Bank, as agent	(n)
(10)(Z)	First Amendment and Waiver to the Amended and Restated Credit Agreement dated as of December 31, 1999	(g)
(10)(AA)	Amendment dated as of April 20, 2000 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company	(o)
(10)(BB)	Lease Agreement dated as of September 1, 2000 between Donegal Mutual Insurance Company and Province Bank FSB	(c)
(10)(CC)	Aggregate Excess of Loss Reinsurance Agreement dated as of January 1, 2001 between Donegal Mutual Insurance Company and Pioneer Insurance Company	(c)
(13)	2001 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report)	Filed herewith
(20)	Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 18, 2002, provided, however, that the Report of the Compensation Committee, the Performance Graph and the Report of the Audit Committee shall not be deemed filed as part of this Form 10-K Report	(p)

Exhibit No. -----	Description of Exhibits -----	Reference -----
(21)	Subsidiaries of Registrant	Filed herewith
(23)	Consent of Independent Auditors	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, 1998.
- (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 10-K Report for the year ended December 31, 1997.
- (e) 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.
- (f) 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.
- (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, 1999.
- (h) 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.
- (i) 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.
- (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, 1988.



- (k) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 33-67346 declared effective September 29, 1993.
- (l) 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.
- (m) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.
- (n) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated November 17, 1998.
- (o) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated May 31, 2000.
- (p) Such exhibit is hereby incorporated by reference to the Registrant's definitive proxy statement filed March 22, 2002.



AMENDED AND RESTATED  
BY-LAWS  
of  
DONEGAL GROUP INC.

Article 1

CORPORATION OFFICE  
-----

Section 1.1. Registered Office. The registered office of the Corporation  
-----  
shall be 1100 North Market Street Building, Wilmington, County of New Castle,  
Delaware, 19801.

Section 1.2. Principal Office. The principal office of the Corporation  
-----  
shall be in Marietta, Pennsylvania.

Section 1.3. Other Offices. The Corporation may also have offices at such  
-----  
other places as the Board of Directors may from time to time designate or the  
business of the Corporation may from time to time require.

Article 2

STOCKHOLDERS  
-----

Section 2.1. Place and Time of Meetings. All meetings of the stockholders  
-----  
shall be held at such time and place as may be fixed from time to time by the  
Board of Directors and stated in the notice of meeting or in a duly executed  
waiver of notice thereof. If no such place is fixed by the Board of Directors,  
meetings of the stockholders shall be held at the principal office of the  
Corporation.

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Section 2.2. Annual Meetings. The annual meeting of the stockholders shall  
-----  
be held on the third Thursday in April in each year, if not a legal holiday,  
and, if a legal holiday, then on the next full business day, at the  
Corporation's principal office or at such other place, date and time as shall be  
designated from time to time by the Board of Directors and stated in the notice  
of meeting or a duly executed waiver of notice thereof.

At such annual meeting, the stockholders shall elect successors to the  
directors whose terms shall expire that year to serve for the following three  
years and until their successors shall have been duly elected and qualified or  
until their earlier resignation or removal. The stockholders also shall transact  
such other business as may properly be brought before the meeting and as are  
consistent with the provisions of these By-laws.

Section 2.3. Stockholder Proposals.  
-----

(a) Stockholder Proposals Relating to Nominations for and Election of  
-----  
Directors.  
-----

(i) Nominations of candidates for election by stockholders to the  
Board of Directors shall be made exclusively by the Nominating Committee of the  
Board of Directors.

(ii) A proposal by a stockholder for the nomination by the Nominating  
Committee of the Board of Directors of a candidate for election by stockholders  
as a director at any meeting of stockholders at which directors are to be  
elected may only be made by notice in writing, delivered in person or by first  
class United States mail postage prepaid or by reputable overnight delivery  
service, to the Nominating Committee of the Board of Directors of the  
Corporation to the attention of the Secretary of the Corporation at the  
principal office of the Corporation, within the time limits specified herein.

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(iii) In the case of an annual meeting of stockholders, any such written proposal of nomination must be received by the Nominating Committee not less than 90 calendar days nor more than 120 calendar days before the first anniversary of the date on which the Corporation first mailed its proxy statement to stockholders for the annual meeting of stockholders in the immediately preceding year; provided, however, that in the case of an annual meeting of stockholders that is called for a date which is not within 30 calendar days before or after the first anniversary date of the annual meeting of stockholders in the immediately preceding year, any such written proposal of nomination must be received by the Board of Directors not less than five business days after the date the Corporation shall have mailed notice to its stockholders that an annual meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that an annual meeting of stockholders will be held.

(iv) In the case of a special meeting of stockholders, any such written proposal of nomination must be received by the Nominating Committee not less than five business days after the earlier of the date that the Corporation shall have mailed notice to its stockholders that a special meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that a special meeting of stockholders will be held.

(v) Such written proposal of nomination shall set forth (A) the name and address of the stockholder who intends to make the nomination (the "Nominating Stockholder"), (B) the name, age, business address and, if known, residence address of each person so proposed, (C) the principal occupation or employment of each person so proposed for the past five years, (D) the number of shares of capital stock of the Corporation beneficially owned within the meaning of Securities and Exchange Commission Rule 13d-3 by each person so proposed and the earliest date of acquisition of any such capital stock, (E) a description of any arrangement or understanding between each person so proposed and the Nominating Stockholder with respect to such person's proposal for nomination and election as a director and actions to be proposed or taken by such person as a director, (F) the written consent of each person so proposed to serve as a director if nominated and elected as a director and (G) such other information regarding each such person as would be required under the proxy solicitation rules of the Securities and Exchange Commission if proxies were to be solicited for the election as a director of each person so proposed.

(vi) If a written proposal of nomination submitted to the Nominating Committee fails, in the reasonable judgment of the Nominating Committee, to contain the information specified in clause (v) hereof or is otherwise deficient, the Chairperson of the Nominating Committee shall, as promptly as is practicable under the circumstances, provide written notice to the Nominating Stockholder of such failure or deficiency in the written proposal of nomination and such Nominating Stockholder shall have five business days from receipt of such notice to submit a revised written proposal of nomination that corrects such failure or deficiency in all material respects.

(vii) Only candidates nominated for election by stockholders as a member of the Board of Directors in accordance with the foregoing provisions of this Section 2.3(a) shall be eligible for election as a member of the Board of Directors at such meeting of stockholders, and any candidate not nominated in accordance with such provisions shall not be considered or acted upon for election as a director at such meeting of stockholders.

(b) Stockholder Proposals Relating to Other Than Nominations for and

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Elections of Directors.  
-----

(i) A stockholder of the Corporation may bring a matter before a meeting of stockholders only if (A) (x) such matter is a proper matter for stockholder action and (y) such stockholder shall have provided notice in writing, delivered in person or by first class United States mail postage prepaid or by reputable overnight delivery service, to the Board of Directors of the Corporation to the attention of the Secretary of the Corporation at the principal office of the Corporation, within the time limits specified herein or (B) the stockholder complies with the provisions of Rule 14a-8 under the Securities Exchange Act of 1934 relating to inclusion of stockholder proposals in the Corporation's proxy statement.

(ii) In the case of an annual meeting of stockholders, any such written notice of presentation of a matter must be received by the Board of Directors not less than 90 calendar days nor more than 120 calendar days before the first anniversary of the date on which the Corporation first mailed its proxy statement to stockholders for the annual meeting of stockholders in the immediately preceding year; provided, however, that in the case of an annual meeting of stockholders that is called for a date which is not within 30 calendar days before or after the first anniversary date of the annual meeting of stockholders in the immediately preceding year, any such written notice of presentation of a matter must be received by the Board of Directors not less than five business days after the date the Corporation shall have mailed notice to its stockholders that an annual meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that an annual meeting of stockholders will be held.

(iii) In the case of a special meeting of stockholders, any such written notice of presentation of a matter must be received by the Board of Directors not less than five business days after the earlier of the date the Corporation shall have mailed notice to its stockholders that a special meeting of stockholders will be held or issued a press release, filed a periodic report with the Securities and Exchange Commission or otherwise publicly disseminated notice that a special meeting of stockholders will be held.

(iv) Such written notice of presentation of a matter shall set forth information regarding such matter equivalent to the information regarding such matter that would be required under the proxy solicitation rules of the Securities and Exchange Commission if proxies were solicited for stockholder consideration of such matter at a meeting of stockholders.

(v) If a written notice of presentation of a matter submitted to the Board of Directors fails, in the reasonable judgment of the Board of Directors, to contain the information specified in clause (iv) hereof or is otherwise deficient, the Chairperson of the Board of Directors shall, as promptly as is practicable under the circumstances, provide written notice to the stockholder who submitted the written notice of presentation of a matter of such failure or deficiency in the written notice of presentation of a matter and such stockholder shall have five business days from receipt of such notice to submit a revised written notice of presentation of a matter that corrects such failure or deficiency in all material respects.

(vi) Only matters submitted in accordance with the foregoing provisions of this Section 2.3(b) shall be eligible for presentation of such meeting of stockholders, and any matter not submitted to the Board of Directors in accordance with such provisions shall not be considered or acted upon at such meeting of stockholders.

Section 2.4. Special Meetings. Special meetings of stockholders for any

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purpose or purposes may be called at any time by the President of the Corporation, and shall be called by the Secretary of the Corporation at the request in writing of a majority of the Board of Directors or stockholders owning at least one-fifth of the entire capital stock of the Corporation issued and outstanding and entitled to vote thereat. Any request for a special meeting of stockholders shall be signed by the person or persons making the request and shall state the purpose or purposes of the proposed meeting. Upon receipt of any such request, it shall be the duty of the Secretary of the Corporation to call a special meeting of stockholders to be held at such time, not less than ten nor more than sixty days thereafter, as the Secretary of the Corporation may fix. If the Secretary of the Corporation shall neglect or refuse to issue such call within five days from the receipt of such request, the person or persons making the request may do so. Business transacted at any special meeting of stockholders shall be limited to the purposes stated in the notice of such meeting or a duly executed waiver of notice thereof.

Section 2.5. Notice of Meetings. Written notice of all meetings of

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stockholders other than adjourned, postponed or continued meetings of stockholders, stating the place, date and hour, and, in the case of special meetings of stockholders, the purpose or purposes thereof, shall be served upon or mailed, postage prepaid, or telegraphed, charges prepaid, not less than ten nor more than sixty days before the date of the meeting to each stockholder entitled to vote thereat at such address as appears on the books of the Corporation. Such notices may be given at the discretion of, or in the name of, the Board of Directors, the President, any Vice President, the Secretary or any Assistant Secretary. When a meeting is adjourned, postponed or continued it shall not be necessary to give any notice of the adjourned, postponed or continued meeting or of the business to be transacted at the adjourned, postponed or continued meeting, other than by announcement at the meeting at which such adjournment, postponement or continuation is taken.



Section 2.6. Participation in Meetings by Conference Telephone. One or more

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stockholders may participate in any meeting of the stockholders by means of conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such person or persons shall be counted for purposes of a quorum.

Section 2.7. Quorum of and Action by Stockholders. The presence, in person,

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by proxy or by telephonic or similar communications equipment, of stockholders entitled to cast a majority of the votes which all stockholders are entitled to cast on the particular matter shall constitute a quorum for purposes of considering such matter, and, unless otherwise specifically provided by statute, the acts of such stockholders at a duly organized meeting shall be the acts of stockholders with respect to such matter.

If, however, such quorum shall not be present at any meeting of the stockholders, the stockholders entitled to vote thereat present in person, by proxy or by such communications equipment may, except as otherwise provided by statute, adjourn, postpone or continue the meeting from time to time to such time and place as they may determine, without notice other than an announcement at the meeting, until a quorum shall be present in person, by proxy or by such communications equipment.

At any adjourned, postponed or continued meeting at which a quorum had been present, stockholders present in person, by proxy or by such communications equipment at a duly organized and constituted meeting, can continue to do business with respect to any matter properly submitted to the meeting until adjournment, postponement or continuation thereof notwithstanding the withdrawal of enough stockholders to leave less than a quorum for the purposes of considering any particular such matter.

Section 2.8. Voting. Except as may be otherwise provided by statute or by

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the Certificate of Incorporation, at every meeting of the stockholders, every holder of Class A Common Stock entitled to vote thereat shall have the right to one-tenth of one vote for every share of Class A Common Stock standing in his name on the stock transfer books of the Corporation on the record date fixed for the meeting and every holder of Class B Common Stock entitled to vote thereat shall have the right to one vote for every share of Class B Common Stock standing in his name on the stock transfer books of the Corporation on the record date fixed for the meeting. No share shall be voted at any meeting if any installment is due and unpaid thereon.

When a quorum exists at any meeting, the vote of the holders of Class A Common Stock and Class B Common Stock having a majority of the voting power present at such meeting in person, by proxy or by telephonic or similar communications equipment shall decide any question brought before such meeting, unless the question is one for which, by express provision of statute or of the Certificate of Incorporation or of these By-laws, a different vote is required. Upon demand made by a stockholder at any election of directors before the voting begins, the election shall be by ballot, in which event the vote shall be taken by written ballot, and the judge or judges of election or, if none, the Secretary of the meeting, shall tabulate and certify the results of such vote.

Section 2.9. Voting by Proxy. Every stockholder entitled to vote at a

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meeting of the stockholders or to express consent or dissent to corporate action in writing without a meeting may authorize another person or persons to act for him by proxy. Every proxy shall be executed in writing by the stockholder or his duly authorized attorney in fact and filed with the Secretary of the Corporation. A proxy, unless coupled with an interest, shall be revocable at will, notwithstanding any other agreement or any provision in the proxy to the contrary, but the revocation of a proxy shall not be effective until written notice thereof has been given to the Secretary of the Corporation. No unrevoked proxy shall be voted or acted upon after three years from the date of its execution, unless a longer time is expressly provided therein. A proxy shall not be revoked by the death or incapacity of the maker, unless, before the vote is counted or the authority is exercised, written notice of such death or incapacity is given to the Secretary of the Corporation.

Section 2.10. Record Date. The Board of Directors may fix a time, not more

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than sixty nor less than ten days prior to the date of any meeting of the stockholders, or the date fixed for the payment of any dividend or distribution, or the date for the allotment of rights or the date when any change or conversion or exchange of shares will be made or go into effect, as the record date for the determination of the stockholders entitled to notice of, or to vote at, such meeting, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares. In such case, only such stockholders as shall be stockholders of record on the date so fixed shall be entitled to notice of, or to vote at, such meeting or to receive payment of such dividend, or to receive such allotment of rights or to exercise such rights, as the case may be, notwithstanding any transfer of any shares on the books of the Corporation after any record date fixed as aforesaid.

The Board of Directors may close the books of the Corporation against transfers of shares during the whole or any part of such period, and in such case written or printed notice thereof shall be mailed at least ten days before the closing thereof to each stockholder of record at the address appearing on the stock transfer books of the Corporation or supplied by him to the Corporation for the purpose of notice. While the stock transfer books of the Corporation are closed, no transfer of shares shall be made thereon. If no record date is fixed by the Board of Directors for the determination of stockholders who are entitled to receive notice of, or to vote at, a meeting of the stockholders, or to receive payment of any such dividend or distribution, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares, transferees of shares which are transferred on the stock transfer books of the Corporation within the ten days immediately preceding the date of such meeting, dividend, distribution, allotment of rights or exercise of such rights shall not be entitled to notice of, or to vote at, such meeting, or to receive payment of any dividend or distribution, or to receive any such allotment of rights or to exercise the rights in respect to any such change or conversion or exchange of shares.

Section 2.11. Stockholders List. The officer or agent having charge of the

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stock transfer books for shares of the Corporation shall make, at least ten days before each meeting of the stockholders, a complete alphabetical list of the stockholders entitled to vote at the meeting, with their addresses and the number of shares held by each, which list shall be kept on file either at a place within the city where the meeting is to be held, which place shall be specified in the notice of the meeting or if not so specified, at the place where the meeting is to be held and shall be subject to inspection by any stockholder for any purpose germane to the meeting at any time during usual business hours for a period of at least ten days prior to the meeting. Such list shall be produced at the meeting and shall be kept open for inspection by any stockholder during the entire meeting. The original stock transfer books of the Corporation shall be prima facie evidence as to who are the stockholders entitled to exercise the rights of a stockholder.

Section 2.12. Inspectors of Election. In advance of any meeting of the

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stockholders, the Board of Directors shall appoint inspectors of election, who need not be stockholders, to act at such meeting or any adjournment, postponement or continuation thereof. If no inspector of election so appointed is able to act at a meeting of stockholders, the chairman of any such meeting shall make such appointment at the meeting. The number of inspectors of election shall be one or three. No person who is a candidate for office shall act as an inspector of election.

The inspectors of election shall do all such acts as may be proper to conduct the election or vote and such other duties as may be prescribed by statute with fairness to all stockholders, and shall make a written report of any matter determined by them and execute a certificate as to any fact found by them. If there are three inspectors of election, the decision, act or certificate of a majority shall be the decision, act or certificate of all.

Section 2.13. Action by Written Consent of the Stockholders. Any action

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required to be taken at an annual or special meeting of stockholders, or of a class thereof, or any action which may be taken at any annual or special meeting of such stockholders, or of a class thereof, may be taken without a meeting, without prior notice and without a vote, if a consent or consents in writing setting forth the action so taken shall be signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted and shall be delivered to the Secretary of the Corporation at its principal place of business as specified in Section 1.2 hereof.

Article 3

DIRECTORS

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Section 3.1. Powers.

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(a) General Powers. The Board of Directors shall have all the power and authority granted by law to the Board of Directors, including all powers necessary or appropriate to the management of the business and affairs of the Corporation.

(b) Specific Powers. Without limiting the general powers conferred by the last preceding clause and the powers conferred by the Certificate of Incorporation and the By-laws of the Corporation, it is hereby expressly declared that the Board of Directors shall have the following powers:

(i) To appoint any person, firm or corporation to accept and hold in trust for the Corporation any property belonging to the Corporation or in which it is interested, and to authorize any such person, firm or corporation to execute any documents and perform any duties that may be requisite in relation to any such trust;

(ii) To appoint a person or persons to vote shares of another corporation held and owned by the Corporation and, in the absence of any such appointment, the Board of Directors of the Corporation shall have the authority to vote any such shares;

(iii) By resolution adopted by a majority of the whole Board of Directors, to designate one or more committees, each committee to consist of two or more of the directors of the Corporation. To the extent provided in any such resolution, and to the extent permitted by law, a committee so designated shall have and may exercise the authority of the Board of Directors in the management of the business and affairs of the Corporation. The Board of Directors may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. If specifically granted this power by the Board of Directors in its resolution establishing the committee, in the absence or disqualification of any member and all designated alternates of such committee or committees or if the whole Board of Directors has failed to designate alternate members, the member or members thereof present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another director to act at the meeting in the place of any such absent or disqualified member;

(iv) To fix the place, time and purpose of meetings of the stockholders; and

(v) To fix the compensation of directors and officers for their services.

Section 3.2. Number and Terms of Directors. The number of directors which

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shall constitute the whole Board of Directors shall be not less than seven nor more than twelve, who shall be natural persons of full age and need not be residents of Delaware or stockholders of the Corporation. Within the limits above specified, the number of directors shall be as determined from time to time by resolution of the Board of Directors. Except as hereinafter provided in the case of vacancies, each director shall be elected by the affirmative vote of a plurality of the votes cast by the holders of Class A Common Stock and of Class B Common Stock for a term of three years and until his successor has been elected, subject to removal as provided by statute.

Section 3.3. Classes. The Board of Directors shall be divided into three

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classes: Class A, Class B and Class C. At each annual meeting of the stockholders, the successors to the directors of the class whose term shall expire in that year shall be elected for a term of three years so that the term of office of one class of directors shall expire in each year. The number of directors in each class shall be as nearly equal as possible so that, except for temporary vacancies, the number in any class shall not exceed the number in any other class by more than one.

Section 3.4. Powers and Duties of the Chairman of the Board of Directors.

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The Board of Directors shall appoint one of their number as the Chairman of the Board who shall preside at all meetings of the Board of Directors and who shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 3.5. Powers and Duties of the Vice Chairman of the Board of

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Directors. The Board of Directors may, in its discretion, appoint one of its

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number as a Vice Chairman of the Board of Directors. In the absence of the Chairman of the Board of Directors, the Vice Chairman of the Board of Directors shall preside at all meetings of the Board of Directors. In addition, the Vice Chairman of the Board of Directors shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 3.6. Vacancies. Vacancies on the Board of Directors, including

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vacancies resulting from an increase in the number of directors, shall be filled by a majority of the remaining members of the Board of Directors, though less than a quorum, or by the sole remaining director, as the case may be, irrespective of whether holders of any class or series of stock or other voting securities of the Corporation are entitled to elect one or more directors to fill such vacancies or newly created directorships at the next annual meeting of the stockholders. Each person so elected shall be a director until his successor is elected by the stockholders at the annual meeting of the stockholders at which the class of directors to which he was elected is up for election or at any special meeting of the stockholders prior thereto duly called for that purpose.



Section 3.7. Organization Meetings. The organization meeting of each newly

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elected Board of Directors shall be held immediately following each annual meeting of the stockholders at which directors were elected without the necessity of notice to such directors to constitute a legally convened meeting or at such time and place as may be fixed by a notice, or a waiver of notice, or a consent signed by all of such directors. At such meeting, the Board of Directors shall elect officers of the Corporation and may also choose an Executive Committee consisting of two members of the Board of Directors in addition to the President.

Section 3.8. Regular Meetings. The Board of Directors shall have the power

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to fix by resolution the place, date and hour of regular meetings of the Board of Directors.

Section 3.9. Special Meetings. Special meetings of the Board of Directors

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may be called by the President of the Corporation on one day's notice to each director, either personally or by mail, telephone or telegram. Special meetings of the Board of Directors shall be called by the President or the Secretary of the Corporation in like manner and on like notice upon the written request of any five directors.

Section 3.10. Notices of Meetings. All meetings of the Board of Directors  
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may be held at such times and places as may be specified in the notice of meeting or in a duly executed waiver of notice thereof. Notice of regular meetings of the Board of Directors shall be given to each director at least three days before each meeting either personally or by mail, telegram or telephone. One or more directors may participate in any meeting of the Board of Directors, or of any committee thereof, by means of a conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such participation in a meeting shall constitute presence in person at the meeting.

Section 3.11. Quorum. At all meetings of the Board of Directors, the  
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presence, in person or by telephonic or similar communications equipment, of a majority of the members of the Board of Directors shall constitute a quorum for the transaction of business, and the acts of a majority of the directors present at a duly convened meeting at which a quorum is present shall be the acts of the Board of Directors, except as may be otherwise specifically provided by statute, by the Certificate of Incorporation of the Corporation or by these By-laws. If a quorum shall not be present, in person or by telephonic or similar communications equipment, at any meeting of the Board of Directors, the directors present may adjourn, postpone or continue the meeting from time to time, without notice other than announcement at the meeting, until a quorum shall be so present.

Section 3.12. Action by Unanimous Written Consent. Any action required or  
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permitted to be taken at any meeting of the Board of Directors or of any committee thereof may be taken without a meeting if all members of the Board of Directors or a committee thereof, as the case may be, consent thereto in writing, and such consent is filed with the minutes of proceedings of the Board of Directors, or committee.

Section 3.13. Compensation. Directors, as such, may receive a stated salary

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for their services, or a fixed sum and expenses for attendance at regular or special meetings of the Board of Directors, or any committee thereof, or any combination of the foregoing as may be determined from time to time by resolution of the Board of Directors, and nothing contained herein shall be construed to preclude any director from serving the Corporation in any other capacity and receiving compensation therefor.

Section 3.14. The Coordinating Committee. The Coordinating Committee shall

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consist of two members of the Corporation's Board of Directors, each of whom is not a member of the Board of Directors or an officer of Donegal Mutual Insurance Company, and two members of the Board of Directors of Donegal Mutual Insurance Company, each of whom is not a member of the Board of Directors or an officer of the Corporation. The Coordinating Committee shall review and either approve or disapprove all contracts and other matters involving actual or potential conflicts of interest between the Corporation and Donegal Mutual Insurance Company. Whenever any new contract between the Corporation and Donegal Mutual Insurance Company is proposed or any change is proposed in any existing contract between the Corporation and Donegal Mutual Insurance Company or any other matter arises that presents an actual or potential conflict of interest between the Corporation and Donegal Mutual Insurance Company, such new contract, change in an existing contract or other matter shall (i) first be submitted for approval to the respective Boards of Directors of the Corporation and of Donegal Mutual Insurance Company, (ii) only following approval by the respective Boards of Directors of the Corporation and Donegal Mutual Insurance Company shall the new contract, change in an existing contract or other matter be submitted to the Coordinating Committee for its consideration thereof and (iii) the

proposed new contract, change in an existing contract or other matter shall be consummated only if (A) both of the Corporation's members of the Coordinating Committee conclude that such new contract, change in an existing contract or other matter is fair and equitable to the Corporation and its stockholders and (B) both of Donegal Mutual Insurance Company's members of the Coordinating Committee conclude that such new contract, change in an existing contract or other matter is fair and equitable to Donegal Mutual Insurance Company and its policyholders. For purposes of this Section 3.14, the term "the Corporation" shall mean Donegal Group Inc. and its direct and indirect wholly owned subsidiaries and the term "Donegal Mutual Insurance Company" shall mean Donegal Mutual Insurance Company and its direct and indirect wholly owned subsidiaries.

Article 4

OFFICERS

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Section 4.1. Election and Office. The officers of the Corporation shall be

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electd annually by the Board of Directors at its organization meeting and shall consist of a President, a Secretary and a Treasurer. The Board of Directors may also elect one or more Vice Presidents and such other officers and appoint such agents as it shall deem necessary. Each officer of the Corporation shall hold office for such term, have such authority and perform such duties as set forth in these By-laws or as may from time to time be prescribed by the Board of Directors in consultation with the President. Any two or more offices may be held by the same person.

Section 4.2. Salaries. The salaries of all officers of the Corporation

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shall be fixed by the Board of Directors.

Section 4.3. Removal and Vacancies. The Board of Directors may remove any

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officer or agent elected or appointed at any time and within the period, if any, for which such person was elected or employed whenever in the judgment of the Board of Directors it is in the best interests of the Corporation, and all persons shall be elected and employed subject to the provisions hereof. If the office of any officer becomes vacant for any reason, the vacancy shall be filled by the Board of Directors.

Section 4.4. Powers and Duties of the President. Unless otherwise

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determined by the Board of Directors, the President shall have the usual duties of a chief executive officer with general supervision over and direction of the affairs of the Corporation. In the exercise of these duties and subject to the limitations of the laws of the State of Delaware or any other applicable law, these By-laws and the actions of the Board of Directors, he may appoint, suspend and discharge employees, agents and assistant officers, may fix the compensation of all officers and assistant officers, shall preside at all meetings of the stockholders at which he shall be present, and, unless there is a Chairman of the Board of Directors, shall preside at all meetings of the Board of Directors and shall be a member of all committees. He shall also do and perform such other duties as from time to time may be assigned to him by the Board of Directors.

Unless otherwise determined by the Board of Directors, the President shall have full power and authority on behalf of the Corporation to attend and to act and to vote at any meeting of the stockholders of any corporation in which the Corporation may hold stock, and, at any such meeting, shall possess and may exercise any and all the rights and powers incident to the ownership of such stock and which, as the owner thereof, the Corporation might have possessed and exercised.

Section 4.5. Powers and Duties of Vice Presidents. Each Vice President

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shall have such duties as may be assigned to him from time to time by the Board of Directors, the Executive Committee or the President. In the event of a temporary absence of the President on vacation or business, the President may designate a Vice President or Vice Presidents who will perform the duties of the President in such absence. In the event of a prolonged absence of the President due to illness or disability or for any other reason, the Board of Directors shall designate a Vice President or Vice Presidents who will perform the duties of the President during such absence.

Section 4.6. Powers and Duties of the Secretary. The Secretary of the

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Corporation shall attend all meetings of the Board of Directors and of the stockholders and shall keep accurate records thereof in one or more minute books kept for that purpose, shall give, or cause to be given, the required notice of all meetings of the stockholders and of the Board of Directors, shall keep in safe custody the corporate seal of the Corporation and affix the same to any instrument requiring it, and when so affixed, it shall be attested by his signature or by the signature of the Treasurer or any Assistant Secretary or Assistant Treasurer of the Corporation. The Secretary also shall keep, or cause to be kept, the stock certificate books, stock transfer books and stock ledgers of the Corporation, in which shall be recorded all stock issues, transfers, the dates of same, the names and addresses of all stockholders and the number of shares held by each, shall, when necessary, prepare new certificates upon the transfer of shares and the surrender of the old certificates, shall cancel such surrendered certificates and shall perform such other duties as may be assigned to him by the President.

Section 4.7. Powers and Duties of the Treasurer. The Treasurer of the

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Corporation shall have the custody of the Corporation's funds and securities, shall keep full and accurate accounts of receipts and disbursements in books belonging to the Corporation, shall deposit all moneys and other valuable effects in the name and to the credit of the Corporation in such depositories as shall be designated by the President, shall disburse the funds of the Corporation as may be ordered by the President or the Board of Directors, taking proper vouchers for such disbursements, shall render to the President and the Board of Directors, at the regular meetings of the Board of Directors or whenever they may require it, an account of all his transactions as Treasurer and of the financial condition of the Corporation and shall have the right to affix the seal of the Corporation to any instrument requiring it, and to attest to the same by his signature and, if so required by the Board of Directors, he shall give bond in such sum and with such surety as the Board of Directors may from time to time direct.

Section 4.8. Designation of a Chief Financial Officer. The Board of

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Directors shall have the power to designate from among the President, any Vice President or the Treasurer of the Corporation a Chief Financial Officer who shall be deemed the principal financial and accounting officer. In the event that the Treasurer is not designated by the Board of Directors as the Chief Financial Officer, the Treasurer shall report to the Chief Financial Officer from time to time concerning all duties which the Treasurer is obligated to perform and the Chief Financial Officer shall, subject to the reasonable direction of the President or the Board of Directors, at his election, assume such of the duties of the Treasurer as are provided in Section 4.7 hereof as he shall deem appropriate.

Article 5

INDEMNIFICATION

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Section 5.1. Indemnification. The Corporation shall indemnify any director  
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or officer of the Corporation and any director or officer of its subsidiaries against expenses, including legal fees, judgments, fines and amounts paid in settlement, actually and reasonably incurred by him to the fullest extent now or hereafter permitted by law in connection with any threatened, pending or completed action, suit or proceeding, whether derivative or nonderivative, and whether civil, criminal, administrative or investigative, brought or threatened to be brought against him by reason of his performance or status as a director or officer of the Corporation, any of its subsidiaries or any other entity in which he was serving at the request of the Corporation or in any other capacity on behalf of the Corporation, its parent or any of its subsidiaries if such officer or director acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the Corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful.

Notwithstanding the foregoing, in the case of any threatened, pending or completed action or suit by or in the right of the Corporation, no indemnification shall be made in respect of any claim, issue or matter as to which such officer or director shall have been adjudged to be liable to the Corporation unless and only to the extent the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the court shall deem proper.



The Board of Directors by resolution adopted in each specific instance may similarly indemnify any person other than a director or officer of the Corporation for liabilities incurred by him in connection with services rendered by him for or at the request of the Corporation or any of its subsidiaries.

The provisions of this Section 5.1 shall be applicable to all actions, suits or proceedings commenced after its adoption, whether such arise out of acts or omissions which occurred prior or subsequent to such adoption and shall continue as to a person who has ceased to be a director or officer or to render services for or at the request of the Corporation and shall inure to the benefit of the heirs, executors and administrators of such a person. The rights of indemnification provided for herein shall not be deemed the exclusive rights to which any such director, officer or other person may be entitled.

Section 5.2. Authorization and Determination of Indemnification. Any

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indemnification under this Article 5, unless ordered by a court, shall be made by the Corporation only as authorized in the specific case upon a determination that indemnification of the director, officer or other person is proper in the circumstances because he has met the applicable standard of conduct as specified in Section 5.1 of this Article 5. A person shall be deemed to have met such applicable standard of conduct if his action is based on the records or books of account of the Corporation or another enterprise, or on information supplied to him by the officers of the Corporation or another enterprise in the course of their duties, or on the advice of legal counsel for the Corporation or another enterprise or on information or records given or reports made to the Corporation or another enterprise by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the Corporation or another enterprise.

Such determination shall be made (i) by the Board of Directors by a majority vote of a quorum consisting of directors who were not parties to such action, suit or proceeding, or (ii) if such a quorum is not obtainable, or, even if obtainable, a majority vote of a quorum of disinterested directors so directs, by independent legal counsel in a written opinion or (iii) by the stockholders. To the extent, however, that a director, officer or other person has been successful on the merits or otherwise in defense of any action, suit or proceeding described above, or in defense of any claim, issue or matter therein, he shall be indemnified against expenses, including attorneys' fees, actually and reasonably incurred by him in connection therewith, without the necessity of authorization in the specific case.

The provisions of this Section 5.2 shall not be deemed to be exclusive or to limit in any way the circumstances in which a person may be deemed to have met such applicable standard of conduct.

Section 5.3. Advances. Expenses incurred in defending or investigating a  
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threatened or pending action, suit or proceeding shall be paid by the Corporation in advance of the final disposition of such action, suit or proceeding as authorized by the Board of Directors upon receipt of an undertaking by or on behalf of the director, officer or other person to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the Corporation as authorized in this Article 5.

Section 5.4. Scope and Alteration of Indemnification Provisions. The  
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indemnification and advancement of expenses provided by, or granted pursuant to, the other sections of this Article 5 shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any By-law, agreement, contract, vote of the stockholders or disinterested directors or pursuant to the direction, howsoever embodied, of any court of competent jurisdiction or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office, it being the policy of the Corporation that indemnification of, and advancement of expenses to, the persons specified in Section 5.1 of this Article 5 shall be made to the fullest extent permitted by law.

To this end, the provisions of this Article 5 shall be deemed to have been amended for the benefit of such persons effective immediately upon any modification of the General Corporation Law of the State of Delaware which expands or enlarges the power or obligation of corporations organized under such law to indemnify, or advance expenses to, such persons. The provisions of this Article 5 shall not be deemed to preclude the indemnification of, or advancement of expenses to, any person who is not specified in this Section 5.4 or Section 5.1 of this Article 5 but whom the Corporation has the power or obligation to indemnify, or to advance expenses for, under the provisions of the General Corporation Law of the State of Delaware or otherwise.

Section 5.5. Insurance. The Corporation may purchase and maintain insurance

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on behalf of any person who is or was a director, officer or employee of the Corporation, or is or was serving at the request of the Corporation as a director, officer or employee of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the Corporation would have the power or the obligation to indemnify him against such liability under the provisions of this Article 5.

Section 5.6. Definitions. For purposes of this Article 5, references to the

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"Corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, and employees or agents, so that any person who is or was a director, officer or employee of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer or employee of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article 5 with respect to the resulting or surviving corporation as he would have with respect to such constituent corporation if its separate existence had continued.

The term "another enterprise" as used in this Article 5 shall mean any other corporation or any partnership, joint venture, trust or other entity of which such person is or was serving at the request of the Corporation as a director, officer, employee or agent and shall include employee benefit plans.

## Article 6

### CAPITAL STOCK

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Section 6.1. Stock Certificates. The certificates for shares of the

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Corporation's capital stock shall be numbered and registered in a share register as they are issued, shall bear the name of the registered holder, the number and class of shares represented thereby and the par value of each share or a statement that such shares are without par value, as the case may be, shall be signed by the President or any Vice President of the Corporation and the Secretary, any Assistant Secretary or the Treasurer of the Corporation or any other person properly authorized by the Board of Directors and shall bear the seal of the Corporation, which seal may be a facsimile engraved or printed. Where the certificate is signed by a transfer agent or a registrar, the signature of any corporate officer on such certificate may be a facsimile engraved or printed. In case any officer who has signed, or whose facsimile signature has been placed upon, any share certificate shall have ceased to be such officer because of death, resignation or otherwise, before the certificate is issued, it may be issued by the Corporation with the same effect as if the officer had not ceased to be such at the date of its issue.

Section 6.2. Transfer of Shares. Upon surrender to the Corporation of a

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share certificate duly endorsed by the person named in the certificate or by an attorney duly appointed in writing and accompanied where necessary by proper evidence of succession, assignment or authority to transfer, a new certificate shall be issued to the person entitled thereto and the old certificate cancelled and the transfer recorded upon the stock transfer books and share register of the Corporation.

Section 6.3. Lost Certificates. Should any stockholder of the Corporation

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allege the loss, theft or destruction of one or more certificates for shares of the Corporation and request the issuance by the Corporation of a substitute certificate therefor, the Board of Directors may direct that a new certificate of the same tenor and for the same number of shares be issued to such person upon such person's making of an affidavit in form satisfactory to the Board of Directors setting forth the facts in connection therewith, provided that prior to the receipt of such request the Corporation shall not have either registered a transfer of such certificate or received notice that such certificate has been acquired by a bona fide purchaser. When authorizing such issuance of a new certificate, the Board of Directors may, in its discretion and as a condition precedent to the issuance of such certificate, require the owner of such lost, stolen or destroyed certificate, or his heirs or legal representatives, as the case may be, to advertise the same in such manner as the Board of Directors shall require and/or to give the Corporation a bond in such form and for such sum and with such surety or sureties, with fixed or open penalty, as shall be satisfactory to the Board of Directors, as indemnity for any liability or expense which it may incur by reason of the original certificate remaining outstanding.

Section 6.4. Dividends. The Board of Directors may, from time to time, at  
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any duly convened regular or special meeting or by unanimous consent, declare  
and pay dividends upon the outstanding shares of capital stock of the  
Corporation in cash, property or shares of the Corporation.

Before payment of any dividend, there may be set aside out of any funds of  
the Corporation available for dividends such sum or sums as the Board of  
Directors from time to time, in its absolute discretion, shall deem proper as a  
reserve fund to meet contingencies, or for equalizing dividends, or for  
repairing or maintaining any property of the Corporation or for such other  
purposes as the Board of Directors shall believe to be in the best interests of  
the Corporation, and the Board of Directors may reduce or abolish any such  
reserve in the manner in which it was created.

#### Article 7

##### FINANCIAL REPORT TO STOCKHOLDERS -----

The President of the Corporation and the Board of Directors shall present  
at each annual meeting of the stockholders a full and complete statement of the  
business and affairs of the Corporation for the preceding year. Such statement  
shall be prepared and presented in whatever manner the Board of Directors shall  
deem advisable and need not be verified by a certified public accountant or sent  
to the stockholders of the Corporation.

Article 8

CHECKS AND NOTES

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All checks or demands for money and notes of the Corporation shall be signed by such officer or officers or such other person or persons as the Board of Directors or the President may from time to time designate.

Article 9

FISCAL YEAR

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The fiscal year of the Corporation shall be as determined from time to time by resolution of the Board of Directors.

Article 10

SEAL

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The seal of the Corporation shall have inscribed thereon the name of the Corporation, the year of its organization and the words "Corporate Seal, Delaware." Said seal may be used by causing it or a facsimile thereof to be impressed or affixed or in any manner reproduced.

Article 11

NOTICES; COMPUTING TIME PERIODS  
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Section 11.1. Method and Contents of Notice. Whenever, under the provisions  
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of statute or of the Certificate of Incorporation or of these By-laws, written notice is required to be given to any person, it may be given to such person either personally or by sending a copy thereof through the mail, postage prepaid, or by telegram, charges prepaid, to his address appearing on the books of the Corporation or supplied by him to the Corporation for the purpose of notice. If the notice is sent by mail or telegraph, it shall be deemed to have been given to the person entitled thereto when deposited in the United States mail or with a telegraph office for transmission to such person. Such notice shall specify the place, day and hour of the meeting, if any, and, in the case of a special meeting of the stockholders, the general nature of the business to be transacted.

Section 11.2. Waiver of Notice. Any written notice required to be given to  
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any person may be waived in a writing signed by the person entitled to such notice whether before or after the time stated therein. Attendance of any person entitled to notice, whether in person or by proxy, at any meeting shall constitute a waiver of notice of such meeting, except where any person attends a meeting for the express purpose of objecting to the transaction of any business because the meeting was not lawfully called or convened. Where written notice is required for any meeting, the waiver thereof must specify the purpose only if it is for a special meeting of the stockholders.

Section 11.3. Computing Time Periods. In computing the number of days for  
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purposes of these By-laws, all days shall be counted, including Saturdays, Sundays or holidays; provided, however, that if the final day of any time period falls on a Saturday, Sunday or holiday, then the final day shall be deemed to be the next day which is not a Saturday, Sunday or holiday. In computing the number of days for the purpose of giving notice of any meeting, the date upon which the notice is given shall be counted but the day set for the meeting shall not be counted.



Article 12

AMENDMENTS

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These By-laws may be altered, amended or repealed by a majority vote of the stockholders entitled to vote thereon at any annual or special meeting duly convened after notice to the stockholders of that purpose or by a majority vote of the members of the Board of Directors at any regular or special meeting of the Board of Directors duly convened after notice to the Board of Directors of that purpose, subject always to the power of the stockholders to change such action of the Board of Directors.

Article 13

INTERPRETATION OF BY-LAWS

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All words, terms and provisions of these By-laws shall be interpreted and defined by and in accordance with the General Corporation Law of the State of Delaware, as amended, and as amended from time to time hereafter.

Last Amended December 20, 2001



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Donegal Mutual Insurance Company  
401(K) Plan ("Plan")

WHEREAS, Donegal Mutual Insurance Company (the "Company") sponsors and maintains the Donegal Mutual Insurance Company 401(K) Plan (the "PLAN"); and

WHEREAS, the Plan reserves to the Company in Section 8.1 the authority to amend the Plan; and

WHEREAS, the Company desires to amend the Plan to clarify provisions concerning the acquisition, holding and disposition of qualifying employer securities;

NOW, THEREFORE, the Plan is hereby amended, subject to the condition subsequent that the Plan, as amended by this Amendment No. 2, be approved by the District Director of Internal Revenue as continuing to be in compliance with the requirements of section 401(a) of the Code, such Amendment to be effective January 6, 2000, as follows:

1. THE PARAGRAPH AT THE END OF PARAGRAPH (B) OF SECTION 4.5 IS DELETED AND THE FOLLOWING SUBSTITUTED THEREFORE:

"Effective January 1, 2000, up to 100 percent of Plan assets may be invested in Qualifying Employer Securities. Moreover, as of such date, each Participant may direct the investment of all or a portion of the Participant's Account in Qualifying Employer Securities which consist of Employer Stock. The duties of the Employer and Trustees concerning such investment and the rights of Participants concerning an investment in Employer Stock are set forth in Section 4.6 below."

2. SECTION 4.6 IS DELETED AND THE FOLLOWING IS SUBSTITUTED THEREFORE:

"4.6 Investment in Employer Stock.  
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(a) Definitions.

(i) Employer Stock means the common stock of Donegal Group Inc., the majority-owned subsidiary of the Employer, as traded on the Nasdaq National Market. Employer Stock which shall be acquired under the Plan shall be purchased on the open market, but the Trustees reserve the power to acquire such Employer Stock directly from Donegal Group Inc.

(ii) Qualifying Employer Security means an Employer Security which is a stock or a marketable obligation (within the meaning of sections 407(d)(5) and 407(e) of ERISA) of the Employer or of its majority-owned subsidiary, Donegal Group Inc. The

Employer Securities which are Qualifying Employer Securities under the Plan shall be limited to Employer Stock (within the meaning of Section 4.6(a)(i)).

(iii) Employer Security means an employer security (as such term is defined in section 407(d)(1) of ERISA) issued by the Employer or by an affiliate (as such term is defined by section 407(d)(7) of ERISA) of the Employer.

(iv) Custodian means Reliance Trust Company, a Georgia corporation. Custodian is an "investment manager" as defined in Section 3(38) of ERISA with respect to Employer Stock.

(v) Record Keeper means TransAmerica. The Record Keeper will maintain all records of the Participants' accounts with respect to investments in Employer Stock.

(b) Purchase and Sale of Employer Stock.

(i) A Participant may direct the Trustee to invest all or a specified portion of the Participant's Elective Contributions and Employer Matching Contributions made on his behalf in Employer Stock. Such direction shall be made on form supplied by the Trustees and maintained by the Record Keeper and in accordance with such procedures as the Plan Administrator may establish. Notwithstanding anything to the contrary contained in this Plan or the Trust Agreement, the Trustees shall, upon receipt of a Participant's direction to invest in Employer Stock in accordance with this Section, direct the Custodian to purchase shares of Employer Stock upon the receipt by the Custodian of contributions from the employees unless such purchase is prohibited by applicable law. Such purchases shall be made pursuant to a nondiscretionary purchasing program developed by the Custodian to effect such purchases in an orderly manner without disruption of the market for such stock or may purchase Employer Stock directly from Donegal Group Inc. and, in either event, in accordance with Section 408(e) of ERISA and other applicable law.

(ii) If a Participant's vested interest in the Participant's Accounts or a portion thereof is to be distributed on account of the Participant's retirement, disability, death, termination of employment, pursuant to a hardship withdrawal, withdrawal of a rollover contribution or as a result of a qualified domestic relations order or because of the minimum distribution rules, the Trustees will direct the Custodian to sell the Participant's shares of Employer Stock or distribute such stock in kind, at the election of the Participant or the Participant's designated beneficiary. If the Participant

elects to take a cash distribution, the amount of cash to be distributed to the Participant attributable to the Participant's shares of Employer Stock will be determined in accordance with Section 4.6(d). Notwithstanding the foregoing, the Custodian may net out transactions internally (so as not to be both a buyer and a seller on the open market) at the prices as determined by the Custodian under Section 4.6(d).

(c) Voting of Shares. Notwithstanding anything to the contrary contained in this Plan or the Trust Agreement, whenever any proxies or consents are solicited from shareholders, each Participant (or designated beneficiary in the case of deceased Participant) whose account contains Employer Stock will have the right to direct the Trustees, in writing, as

to the voting of such shares. The Trustees or the Custodian will use their best efforts to distribute or cause to be distributed in a timely manner to each Participant or designated beneficiary a copy of the proxy solicitation material sent to shareholders, together with a form addressed to the Trustees or the Custodian containing confidential, written instructions as to the manner in which said shares will be voted. If the instructions are sent to the Custodian, the Custodian must communicate the instructions to the Trustees. Upon receipt of such instructions, the Trustees will vote said shares as instructed. Shares of Employer Stock as to which the Trustees do not receive instructions will be voted by the Trustees in the proportion to the voting of shares with respect to which instructions are received. Each Participant (or designated beneficiary) will be entitled to one vote for each full share of Employer Stock allocated to the Participant's accounts. Fractional shares of Employer Stock will not be permitted to vote.

(d) Valuation. Employer Stock will be valued as of any business day of each Plan Year at the closing price for such stock on the Nasdaq National Market on the date on which such valuation is being made or under such other method of determining fair market value as shall be authorized by the Code, or the rules or regulations thereunder, and adopted by the Custodian. Any dividends received on Employer Stock will be reinvested and become part of the Participant's Accounts. The Record Keeper will maintain adequate records of the cost basis of Employer Stock for each Participant's account. The Record Keeper may from time to time modify its accounting procedures to achieve equitable and nondiscriminatory allocations among the Matching Contribution Accounts of Participants in accordance with the provisions of this Plan and the requirements of applicable law.

(e) Named Fiduciary Status / Confidentiality. Each Participant or designated beneficiary shall be deemed to be a named fiduciary within the meaning of Section 402(a) of ERISA with respect to the voting of the shares of Employer Stock as to which such Participant or designated beneficiary has the right of direction. Directions received from Participants or designated beneficiaries by the Trustees or the Custodian with respect to the acquisition, holding, disposition or voting of Employer Stock shall be held in strict confidence and shall not be divulged or released to any person, including employees, officers or directors of the Employer, to the extent required by and in accordance with Section 404(c) of ERISA, except if disclosure is otherwise required by applicable law, and except to the extent necessary for the operation of the Plan, such directions may be relayed by the Trustees to the Record Keeper or auditor for the Plan, which Record Keeper or auditor is not the Employer.

IN WITNESS WHEREOF and as evidence of the adoption of this Amendment No. 2, Donegal Mutual Insurance Company has caused its duly authorized officers to execute this document of its behalf and under its seal as of this 6th day of January, 2000.

DONEGAL MUTUAL INSURANCE COMPANY

ATTEST:

/s/ Ralph G. Spontak

By: /s/ Donald H. Nikolaus

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Ralph G. Spontak, Secretary

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Donald H. Nikolaus, President and  
Chief Executive Officer

[Corporate Seal]



Donegal Mutual Insurance Company  
401(K) Plan ("Plan")

In accordance with Section 8.1 of the Plan, the Plan is hereby amended effective January 1, 2000, except as otherwise provided herein:

1. Subsection (d) of Section 1.1 is deleted and the following substituted therefore:

"1.1(d) 'Employee' means any individual employed by the Employer or an affiliated Employer, except that such term does not include:

- (i) Any Leased Employee as defined herein and
- (ii) Any Employee who is hired as a temporary employee and whose employment is to be of limited duration generally not in excess of six (6) months.

Leased Employee means any person (other than an Employee of the Recipient) who pursuant to an agreement between the Recipient and any other person ("Leasing Organization") has performed services for the Recipient or for the Recipient and related persons determined in accordance with IRC Section 414(n)(6) on a substantially fulltime basis for a period of at least one year, and such services are performed under the Recipient's primary direction or control. For purposes of the preceding sentence Recipient means the Employer as defined herein.

1.A. Subsection (j) of Section 1.1 is amended by revising subparagraph 1 of the last paragraph of that sentence so that the subparagraph as amended reads as follows:

"(1) Compensation is compensation within the meaning of IRC Section 415(c)(3) including elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax sheltered annuity and elective amounts that are not includable in the gross income of an Employee by reason of Section 132(f)(4) of the Code' and"

1.B. Paragraph (d) of Section 1.3 is amended by revising the last sentence thereof so that it reads as follows:

"The foregoing notwithstanding, compensation shall include any elective contributions made by the Employer that are not includable in the Employee's gross income under Code Sections 125, 132(f)(4), 402(g)(3), 402(h), 403(b) or any compensation deferred under Code Section 457(b)."

2. The words "calendar quarter" in Section 3.2 are deleted and the word "month" is substituted therefore.
3. Subsections (f) and (g) of Section 3.8 are deleted.
4. There is hereby added at the end of subsection (b) of Section 3.11 the following sentence:  

"Rollover amount does not include hardship withdrawals as defined in Code Section 401(k)(2)(B)(i)(IV) which are attributable to the Participant's Elective Deferrals.
5. Subsection (c) of Section 4.3 is deleted and the following substituted therefore: "(c) Increased by the Employer's matching contributions which shall be allocated to each Participant's Employer matching contribution account to the extent not previously so allocated; and"
6. Section 4.4 is hereby deleted.
7. There is hereby added to subsection (d) of Section 3.6 new paragraph 5 reading as follows:  

"5. The ADP test will be conducted using the Prior Year testing method; provided that the Employer may at any time amend the Plan to change to the current year testing method, but only with the prior permission of the Secretary of the Treasury or his delegate. For the first year of operation of the qualified cash or deferred arrangement under this Plan, the ADP of non-highly compensated Employees shall be deemed to be 3%."
8. Section 10.2 is deleted and the following substituted therefore:

Section 10.2 Alienation. (a) In General. Except as provided in Subsections (b) and (c) of this Section, or pursuant to an order of a court of competent jurisdiction to the contrary, none of the payments, benefits or rights of any Participant, Beneficiary, prospective beneficiary or alternate payee shall be subject to any claim of any creditor. In particular, to the fullest extent permitted by law, all such payments, benefits and rights shall be free from attachment, garnishment, trustee's process, or any other legal or equitable process available to any creditor of such Participant, Beneficiary, prospective beneficiary or alternate payee. Except as provided in Subsection (b) of this Section, no person entitled to any payment, benefit or right under the Plan shall have the right to alienate, anticipate, commute, pledge, encumber or assign any of the payments, benefits or rights which he may expect to receive,



contingently or otherwise, under the Plan.

(b) Exceptions. The following shall not be precluded by the operation of Subsection (a) hereof:

(1) the withholding of income taxes from distributions (whether by legal mandate or by election of the prospective distributee) and transmittal of the amounts so withheld to appropriate tax collection authorities;

(2) the pledge by a borrower from the Plan (and foreclosure on the pledged amount by the lender or other hold of the borrower's debt obligation) of any portion of his interest in the Plan as security for the repayment of the amount borrowed, interest payable in respect thereof, and costs and expenses associated therewith;

(3) any arrangement for the recovery by the Plan of overpayments of benefits previously made to or for the benefit of the Participant or other person with respect to whom such arrangement applies:

(4) transfer of any eligible rollover distribution amount from the Plan to any other benefit plan qualified under section 401(a) of the Code or to an individual retirement arrangement established under section 408 of the Code;

(5) direct deposit arrangements with respect to benefits if the direct deposits authorized by such arrangement is to an account of the payee (or a joint account of the payee and his spouse) at a bank or other financial institution;

(6) any assignment or alienation of benefits in pay status to the extent that such assignment or alienation (i) is voluntary and revocable, (ii) is not for the purpose of, nor has the effect of, defraying Plan administration costs; and (iii) does not, when combined with all other such assignments in the aggregate, exceed ten percent (10%) of any benefit payment;

(7) any assignment to the Plan Sponsor if (i) such assignment is revocable at any time, and (ii) the Plan Sponsor files with the Plan Administrator a written acknowledgment meeting the requirements of Treas. Reg. Section 1.401(a)-13(e)(2) (or a successor regulation of similar purpose); and

(8) the enforcement of a federal tax levy made pursuant to section 6331 of the Code or the collection by the United States on a judgment resulting from an unpaid tax assessment.

(c) Applicability of a QDRO. Compliance with the provisions and conditions of any QDRO shall not be deemed a violation of the provisions of Subsection (a) hereof."

9. There is hereby added to the Plan new Section 10.5(a) reading as follows:

"Section 10.5(a) Restrictions-Assets from Money Purchase Pension Plan. Notwithstanding any provision of this Plan to the contrary, if any optional form of benefit under this Plan permits a distribution prior to a Participant's retirement, death or disability or severance from employment and prior to Plan termination, that optional form of benefit shall not be available with respect to the benefits attributable to assets (including post transfer earnings and

appreciation thereon) and liabilities that are transferred within the meaning IRC 414(1) to this Plan from a money purchase plan (other than any portion of those assets and liabilities attributable to voluntary Employee contributions)."

IN WITNESS WHEREOF and as evidence of the adoption of this amendment, Donegal Mutual Insurance Company has caused its duly authorized officers to execute this document on its behalf and under its seal this 29th day of October, 2001, to be effective as of the 23rd day of July 2001.

Donegal Mutual Insurance Company

ATTEST:

/s/ Ralph G. Spontak

By: /s/ Donald H. Nikolaus

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Ralph G. Spontak, Secretary

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Donald H. Nikolaus, President

[Corporate Seal]



Donegal Mutual Insurance Company  
401(K) Plan ("Plan")

EGTRRA AMENDMENT

In accordance with Section 8.1 of the Plan, the Plan is amended as follows:

Preamble. This amendment is intended as good faith compliance with the requirements of EGTRRA and is to be construed in accordance with EGTRRA and the guidance issued thereunder. Except as otherwise expressly provided, this amendment is effective as of the first day of the first Plan Year beginning after December 31, 2001. This amendment supercedes the provisions of the Plan to extent they are inconsistent with the provisions of this amendment.

1. Section 3.4(b), Limitation on Contributions.

(b) Maximum Annual Addition. Except to the extent permitted under Section 8 of this amendment and Section 414(v) of the Code, if applicable, the annual addition that may be contributed or allocated to a Participant's account under the Plan for any limitation year, shall not exceed the lesser of:

1. \$40,000.00 as adjusted for increases in the cost of living under Section 415(d) of the Code, or

2. 100% of the Participant's compensation, within the meaning of Section 415(c)(3) of the Code, for the limitation year.

2. Section 1.1(d)(1), Increase in Compensation Limit.

(1) The annual compensation of each Participant taken into account in determining allocations for any Plan Year beginning after December 31, 2001, shall not exceed \$200,000.00, as adjusted for cost of living increases in accordance with Section 401(a)(17)(B) of the Code. Annual compensation means compensation during the Plan Year or such other consecutive 12 month period over which compensation is otherwise determined hereunder. A cost of living adjustment in effect for a calendar year applies to the annual compensation for the determination period that begins with or within such calendar year.

3. Modification of Top-Heavy Rules.

Article IX - Top Heavy Provisions and Definitions.  
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9.1(d). Key employee. Key employee means any employee or former employee (including any deceased employee) who at any time during the Plan Year that includes the determination date was an officer of the Employer having annual compensation greater than

\$130,000.00 (as adjusted under Section 416(i)(1) of the Code for Plan Years beginning after December 31, 2002), a 5-percent owner of the Employer, or a 1-percent owner of the Employer having annual compensation of more than \$150,000.00. For this purpose, annual compensation means compensation within the meaning of Section 415(c)(3) of the Code. The determination of who is a key employee will be made in accordance with Section 4169(i)(1) of the Code and the applicable regulations and other guidance of general applicability issued thereunder.

9.1(i). Determination of present values and amounts. This Section 9.1(i) shall apply for purposes of determining the present values of accrued benefits and the amounts of account balances of employees as of the determination date.

(a) Distributions during year ending on the determination date. The present value of accrued benefits and the amounts of account balances of an employee as of the determination date shall be increased by the distributions made with respect to the employee under the Plan and any plan aggregated with the Plan under Section 416(g)(2) of the Code during the 1-year period ending on the determination date. The preceding sentence shall also apply to distributions under a terminated Plan which, had it not been terminated, would have been aggregated with the plan under Section 416(g)(2)(A)(i) of the Code. In the case of a distribution made for a reason other than separation from service, death, or disability, this provision shall be applied by substituting 5-year period for 1-year period.

(b) Employees not performing services during year ending on the determination date. The accrued benefits and accounts of any individual who has not performed services for the Employer during the 1-year period ending on the determination date shall not be taken into account.

9.7 Minimum benefits.

(a) Matching contributions. Employer matching contributions shall be taken into account for purposes of satisfying the minimum contribution requirements of Section 416(c)(2) of the Code and the Plan. The preceding sentence shall apply with respect to matching contributions under the Plan or, if the Plan provides that the minimum contribution requirement shall be met in another plan, such other plan. Employer matching contributions that are used to satisfy the minimum contribution requirements shall be treated as matching contributions for purposes of the actual contribution percentage test and other requirements of Section 401(m) of the Code.

(b) The minimum contribution requirements of Section 416(c)(2) of the Code shall be met in this Plan.

4. Direct Rollovers of Plan Distribution.

A. Modification of Definitions. For purposes of the direct roll over provisions in Section 3.5, an eligible retirement plan shall also mean an annuity contract described in Section 403(b) or 457(b) of the Code an ineligible plan under Section 457(b) of the Code which is maintained by a state, political subdivision of a state, or any agency or

instrumentality of a state or a political subdivision thereof which agrees to separately account for amounts transferred into such plan from this Plan. The definition of eligible retirement plan shall also apply in the case of a distribution to a surviving spouse or to a spouse or former spouse who is the alternate payee under a qualified domestic relations order as defined in Section 414(p) of the Code.

B. Any amount that is distributed on account of hardship shall not be an eligible rollover distribution and the distributee may not elect to have any portion of such distribution paid directly to an eligible retirement plan.

5. Rollovers from other plans.

A. Direct rollovers. Pursuant to Section 3.3, the Plan will accept Participant rollover contributions and direct rollover of an eligible distribution from

(i) A qualified plan described in Section 401(a) or 403(a) of the Code, excluding after tax employee contributions.

(ii) An annuity contract described in Section 403(b) of the Code, excluding after tax employee contributions.

(iii) An eligible plan under Section 457(b) of the Code which is maintained by a state, political subdivision of the state or any agency or instrumentality of a state or political subdivision of a state.

(iv) A participant rollover contribution of the portion of the distribution from an individual retirement account or annuity described in Section 408(a) or 408(b) of the Code that is eligible to be rolled over and would otherwise be includable in gross income.

B. Rollovers disregarded in involuntary cash outs. The value of a Participant's non-forfeitable account balance shall be determined without regard to that portion of the account balance that is attributable to rollover contributions (and earnings allocable thereto) within the meaning of Sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3)(A)(ii) and 457(e)(16) of the Code. If the value of the Participant's nonforfeitable account balance as so determined is \$5,000.00 or less, the Plan shall immediately distribute the participant's entire nonforfeitable account balance.

6. Repeal of multiple use test. The multiple use test described in Treasury Regulation Section 1.401(m)-2 shall not apply to Plan Years beginning after December 31, 2001.

7. Elective deferrals - contribution limitation. No Participant shall be permitted to have Elective Deferrals under this Plan or any other qualified plan maintained by the Employer during any taxable year in excess of the dollar limitation contained in Section 402(g) of the Code in effect for such taxable year, except to the extent permitted under Section 8 of this amendment (catch up contribution).

8. Catch-up contributions. All employees who are eligible to make Elective Deferrals hereunder and who have attained age 50 before the close of the Plan Year shall be eligible to make catch-up contributions in accordance with, and subject to the limitation of, Section 414(v) of the Code. Such catch-up contributions shall not be taken into account for purposes of the provisions of this Plan implementing the required limitations of Sections 402(g) and 415 of the Code. This Plan shall not be treated as failing to satisfy the provisions of the Plan implementing the requirements of Sections 401(k)(3), 401(k)(11), 401(k)(12), 410(b) or 416 of the Code as applicable, by reason of the making of such catch-up contributions.

9. Suspension period following hardship distributions. A Participant who receives a distribution of Elective Deferrals after December 31, 2001 on account of hardship shall be prohibited from making Elective Deferrals under this and all other plans maintained by the Employer for 6 months after receipt of the distribution. A Participant who receives a distribution of Elective Deferrals in calendar year 2001 on account of hardship shall be prohibited from making Elective Deferrals and employee contributions under this Plan and all other plans maintained by the Employer for 6 months after the receipt of the distribution or until January 2, 2002, if later.

10. Distribution upon severance of employment. A Participant's Elective Deferrals, qualified non-elective contributions, qualified matching contributions and earning attributable thereto shall be distributed on account of the Participant's severance from employment. However, such distribution shall be subject to the other provisions of this Plan regarding distributions, other than provisions that require a separation from service before such amounts may be distributed. This Section shall apply to a Participant's severance from employment occurring after December 31, 2001.

In Witness Whereof, the Employer has caused its duly authorized officers to execute this amendment as of the day and year first above written.

Donegal Mutual Insurance Company

By: /s/ Donald H. Nikolaus

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Donald H. Nikolaus

Attest:

/s/ Ralph G. Spontak

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Ralph G. Spontak, Secretary

[Corporate Seal]





Donegal Mutual Insurance Company  
401(K) Plan ("Plan")

In accordance with Section 8.1 of the Plan, the Plan is hereby amended effective December 31, 2001 as follows:

1. Sections 12.2, 12.3 and 12.4 are deleted and the following substituted therefore:

"Section 12.2 Profit Sharing Benefit. The term Profit Sharing Benefit means the account balance of the Participant in the Participant's Profit Sharing Account as of December 31, 2001. Effective December 31, 2001, the full amount of that benefit shall be transferred to and become a part of the Participant's Elective Deferral Account in this Plan and thereafter be subject to the provisions of this Plan other than this Article XII."

IN WITNESS WHEREOF and as evidence of the adoption of this Amendment No. 5, Donegal Mutual Insurance Company has caused its duly authorized officers to execute this document on its behalf and under its seal this 20th day of December, 2001.

Donegal Mutual Insurance Company

ATTEST:

By: /s/ Donald H. Nikolaus

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Donald H. Nikolaus, President

/s/ Ralph G. Spontak

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Ralph G. Spontak, Secretary

(Corporate Seal)

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#### MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Donegal Group Inc. ("DGI" or the "Company") is a regional insurance holding company doing business in the Mid-Atlantic and Southern states through its four wholly owned property-casualty insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage") and Pioneer Insurance Company of Ohio ("Pioneer-Ohio") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. DGI was formed in September 1986 by Donegal Mutual Insurance Company (the "Mutual Company"), which owns 63% of the outstanding common shares of the Company as of December 31, 2001.

Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 70% of the pooled business (65% prior to July 1, 2000). Southern cedes 50% of its business to the Mutual Company. Because the Mutual Company places substantially all of the business assumed from Southern into the pool, from which the Company has a 70% allocation, the Company's results of operations include approximately 85% of the business written by Southern.

In addition to the Company's Insurance Subsidiaries, it also owned all of the outstanding stock of Atlantic Insurance Services, Inc., ("AIS"), an insurance services organization. The Company sold all of the outstanding shares of AIS on October 1, 1999.

During 2000, the Company acquired 45% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a bank holding company. The remaining 55% of the outstanding stock of DFSC is owned by the Mutual Company.

On January 3, 2001, the Company announced that it had purchased all of the outstanding stock of Pioneer Insurance Company of New York ("Pioneer-New York") from the Mutual Company effective January 1, 2001. The purchase price was \$4,441,311, representing Pioneer-New York's adjusted statutory equity at December 31, 2000. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interests, as both Pioneer-New York and the Company are under the common management and control of the Mutual Company. As such, the Company's financial statements have been restated to include Pioneer-New York as a consolidated subsidiary. In connection with this transaction, the Company issued the Mutual Company a \$4,441,311 note, which bears a 6% rate and was due in one year. The due date was subsequently extended to January 2003. The 6% rate was based upon commercial market rates in effect as of January 1, 2001.

Delaware Atlantic Insurance Company ("Delaware"), previously a wholly owned subsidiary, and Pioneer-New York were merged into Atlantic States Insurance Company on August 1, 2001 and September 30, 2001, respectively. The mergers were accounted for as statutory mergers and had no financial impact on the consolidated entity.

#### TRANSACTIONS WITH AFFILIATES

The Company's insurance subsidiaries have various reinsurance arrangements with the Mutual Company, which include a pooling agreement with Atlantic States, a 50% quota share contract with Southern, catastrophe reinsurance agreements with each of the subsidiaries and excess of loss reinsurance agreements with Southern, Southern Heritage and Pioneer-Ohio. The Mutual Company also has 100% retrocessional agreements with Southern, Southern Heritage and Pioneer-Ohio. Each contract is reviewed by a Coordinating Committee comprised of two board members of the Company and two board members of the Mutual Company. This

committee reviews the business purpose and terms of each agreement based on degree of risk, fairness to the participating companies and market conditions. The committee must unanimously approve all agreements and all changes to existing agreements between the Company's subsidiaries and the Mutual Company.

The pooling agreement between the Mutual Company and Atlantic States is intended to produce a more uniform and stable underwriting result from year to year for the participants in the pool than they would experience individually and to spread the risk of loss

among the participants. Each company participating in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposure of a size commensurate with its own capital and surplus. In addition, the ability of the Company to raise capital, and infuse that capital into Atlantic States, provides the participants of the pool with an ability to grow their total direct premiums at a greater rate than would be possible without the existence of the pool. Premiums, losses, loss expenses and underwriting expenses are shared proportionately by each of the participants, with Atlantic States currently assuming 70% of the pooled business and the Mutual Company retaining 30% of the pooled business.

The 50% quota share reinsurance contract between Southern and the Mutual Company provides additional capacity for direct premium growth to Southern during periods of growth that exceeds Southern's ability to finance that growth through internal equity. Premiums, losses and loss expenses are shared equally by the participants with the Mutual Company paying commissions to Southern to reimburse its costs related to the underwriting process.

The excess of loss and catastrophe reinsurance agreements are intended to lessen the effects of a single large loss, or an accumulation of losses arising from one event, to a level that is more in line with each company's size, underwriting profile and equity position. The retention levels of these contracts are more appropriate for each company than the retention levels included within reinsurance contracts with outside reinsurers, which may be appropriate for the insurance companies taken as a whole but would be excessive for any individual company within the group.

The 100% retrocessional agreements are intended to provide the subsidiaries with the same A.M. Best rating (currently "A") as the Mutual Company, which these companies could not achieve without these contracts in place.

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled \$29,298,569, \$26,985,080 and \$27,466,898 for 2001, 2000 and 1999, respectively.

#### CRITICAL ACCOUNTING POLICIES

The Company's financial statements are combined with those of its subsidiaries and presented on a consolidated basis in accordance with U.S. generally accepted accounting principle.

The Company uses estimates and assumptions that can have a significant effect on the amounts that are reported in its financial statements. The Company believes the following are its most significant accounting policies as they may require a higher degree of judgment and estimation.

#### LIABILITY FOR LOSSES AND LOSS EXPENSES

The most significant estimates relate to reserves for losses and loss expenses. The liability represents estimates of the ultimate unpaid cost of claims incurred, including claims incurred but not reported to the Company as of the close of the reporting period. The estimates of losses for reported claims are based on reviews of the individual claims considering known information and the policy provisions relating to the loss. Estimates of losses and loss expenses for unreported claims are established based on historical data by line of insurance as adjusted for current conditions considering factors such as inflation, recent trends and other analysis of costs. The Company continually reviews and analyzes its estimates, but actual losses may turn out to be significantly different than expected when the estimates were made.

#### INVESTMENTS

In the Company's investment portfolio, the difference between cost and the fair value of investments is monitored regularly. The Company evaluates significant declines in fair value below cost on an individual investment basis. This evaluation considers the magnitude of the decline below cost, the period of time the investment has been significantly below cost and the prospects for the fair value to recover in the near term. If any investment experiences a decline in value that is believed to be other than temporary, the cost basis of the investment is written down and a realized loss is recorded in earnings.

#### REINSURANCE

Reinsurance accounting is followed when risk transfer requirements have been met. These requirements may involve significant assumptions being made related to the amount and timing of expected cash flows, as well as interpretation of the underlying contract terms.

#### POLICY ACQUISITION COSTS

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other variable underwriting costs, are deferred and amortized over the period in which the premiums are earned. Anticipated losses and loss expenses, expenses for maintenance of policies in force and anticipated investment income are estimated in the determination of the recoverability of deferred acquisition

costs. Future changes in estimates, the most significant of which is expected loss and loss expenses, may require adjustment to policy acquisition costs.

## RESULTS OF OPERATIONS 2001 COMPARED TO 2000

Total revenues for 2001 were \$185,163,623, which were \$14,582,036, or 8.5%, greater than 2000. Net premiums earned increased to \$167,769,854, an increase of \$16,123,655, or 10.6%, over 2000. The change in Atlantic State's share of the pooling arrangement with the Mutual Company from 65% to 70% effective July 1, 2000, accounted for \$4,273,297 of the increase in net premiums earned. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased \$23,152,222 or 13.2%. A 4.0% increase in the direct premiums written of Southern, an 8.6% increase in the direct premiums written of Pioneer-Ohio and a 9.6% increase in the direct premiums written of Southern Heritage accounted for the majority of the remaining change. The Company reported net realized investment losses of \$880,254 in 2001 compared to net realized investment gains of \$170,852 in 2000. During 2001 and 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of \$1,462,913 and \$436,943 were included in net realized investment gains (losses) for these investments in 2001 and 2000, respectively. The remaining realized gains and losses in both years resulted from normal turnover of the Company's investment portfolio. As of December 31, 2001, 100.0% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income decreased \$509,203 in 2001. An increase in the average invested assets from \$278,677,748 to \$294,988,999, offset by a decrease in the average yield to 5.3% from 5.9% in 2000, accounted for the change.

The GAAP combined ratio of insurance operations was 103.8% in 2001, compared to 101.8% in 2000. The combined ratio is the sum of the ratios of incurred losses and loss expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 2001 was 70.5% compared to 68.8% in 2000. The increased loss ratio reflected the impact of loss and loss expense reserve strengthening of approximately \$4.2 million in the commercial automobile and workers' compensation lines of business. The commercial lines loss ratio increased significantly to 72.7% in 2001 compared to 67.0% in 2000. The personal lines loss ratio decreased from 70.3% in 2000 to 69.2% in 2001. The commercial automobile and workers' compensation loss ratios showed considerable deterioration in 2001 with the commercial automobile loss ratio increasing to 85.0% in 2001 compared to 78.1% in 2000 and the workers' compensation loss ratio increasing to 82.5% in 2001 compared to 64.2% in 2000. The expense ratio for 2001 was 32.3% compared to 32.1% in 2000 with the dividend ratio increasing slightly to 1.0% in 2001 compared to 0.9% in 2000. The expense ratio in 2001 included a guaranty fund assessment of approximately \$543,000 resulting from the insolvency of Reliance Insurance Company. This assessment accounted for most of the increase in the expense ratio.

Income tax expense was \$1,273,598, an effective rate of 18.0%, compared to \$2,906,248, an effective rate of 24.7% in 2000. Tax exempt interest represented a larger proportion of net income before taxes in 2001 as compared to 2000, accounting for most of this difference.

## RESULTS OF OPERATIONS 2000 COMPARED TO 1999

Total revenues for 2000 were \$170,581,587, which were \$8,842,251, or 5.5%, greater than 1999. Net premiums earned increased to \$151,646,199, an increase of \$6,128,742, or 4.2%, over 1999. The change in Atlantic State's share of the pooling arrangement with the Mutual Company from 65% to 70% effective July 1, 2000, accounted for \$4,113,078 of the increase in net premiums earned. Direct premiums written of the combined pool of Atlantic States and the Mutual Company increased \$13,851,692 or 9.0%. A 5.1% increase in the direct premiums written of Southern, a 2.1% decrease in the direct premiums written of Delaware, a 13.2% increase in the direct premiums written of Pioneer-New York, a 25.4% increase in the direct premiums written of Pioneer-Ohio and a 15.6% decrease in the direct premiums written of Southern Heritage accounted for the majority of the remaining change. The Company reported net realized investment gains of \$170,852, compared to net realized investment losses of \$38,702 in 1999. During 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of \$436,943 were included in net realized investment gains for these investments in 2000. Net realized gains and losses in 1999 resulted from normal turnover of the Company's investment portfolio. As of December 31, 2000, 100.0% of the Company's bond portfolio was classified as Class 1 (highest quality) by the National Association of Insurance Commissioners' Securities Valuation Office. Investment income increased \$2,804,052 in 2000. An increase in the average invested assets from \$264,758,816 to \$278,677,748, and an increase in the average yield to 5.9% from 5.1% in 1999, accounted for the change.

The GAAP combined ratio of insurance operations was 101.8% in 2000, compared to 106.5% in 1999. The GAAP combined ratio is the sum of the ratios of incurred losses and loss expenses to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in both 2000 and 1999 was 68.8%. The commercial lines loss ratio decreased from 68.8% in 1999 to 67.0% in 2000. The personal lines loss ratio increased from 69.7% in 1999 to 70.3% in 2000. The expense ratio for 2000 was 32.1%, compared to 36.8% in 1999, with the dividend ratio remaining unchanged at 0.9%. The expense ratio in 1999 was adversely affected by a charge to earnings resulting from a restructuring charge of \$1.6 million which increased the expense ratio by 1.1%.

Income tax expense (benefit) was \$2,906,248, compared to \$(2,950,556) in 1999. The Company benefited from a federal income tax law change in 1999.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment earnings and maturing investments. As of December 31, 2001, the Company had no material commitment for capital expenditures.

In investing funds made available from operations, the Company maintains securities' maturities consistent with its projected cash needs for the payment of claims and expenses. The Company maintains a portion of its investment portfolio in relatively short-term and highly liquid assets to ensure the availability of funds.

As of December 31, 2001, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, the Company had unsecured borrowings of \$27.6 million. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer-Ohio and Southern Heritage and various capital contributions to the subsidiaries. As of December 31, 2001, the Company may borrow up to \$32 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 2001, the interest rates were 4.75% on an outstanding prime rate balance of \$2.6 million, 3.825% on an outstanding Eurodollar rate balance of \$10 million and 3.6375% on another Eurodollar rate balance of \$15 million. In addition, the Company pays a rate of 3/10 of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, the credit line is reduced by \$8 million. Any outstanding loan in excess of the remaining credit line, after such reduction will then be payable.

The Company's principal sources of cash with which to meet obligations and pay stockholder dividends are dividends from the Insurance Subsidiaries which 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. The Insurance Subsidiaries are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 2001, all four companies' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to DGI without prior approval of the insurance regulatory authorities in 2002 are \$8,612,490 from Atlantic States, \$1,086,348, from Southern, \$552,447 from Pioneer-Ohio and \$3,514,487 from Southern Heritage.

Net unrealized gains (losses) resulting from fluctuations in the fair value of investments reported in the balance sheet at fair value were \$2,861,765 (net of applicable federal income tax benefit) at December 31, 2001, and \$(199,063) (net of applicable federal income tax) at December 31, 2000.

#### CREDIT RISK

The Company provides property and liability coverages through its subsidiaries' independent agency systems located throughout its operating area. The majority of this business is billed directly to the insured, although a portion of the Company's commercial business is billed through its agents, who are extended credit in the normal course of business.

The Company's Insurance Subsidiaries have reinsurance agreements in place with the Mutual Company, as described in Note 2 of the financial statements, and with a number of other major authorized reinsurers, as described in Note 8 of the financial statements.

#### IMPACT OF INFLATION

Property and casualty insurance premiums are established before the amount of losses and loss expenses, or the extent to which inflation may impact such expenses, are known. Consequently, the Company attempts, in establishing rates, to anticipate the potential impact of inflation.



QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK  
INTEREST RATE RISK

The Company's exposure to market risk for changes in interest rates is concentrated in its investment portfolio and, to a lesser extent, its debt obligations. The Company monitors this exposure through periodic reviews of asset and liability positions. Estimates of cash flows and the impact of interest rate fluctuations relating to the investment portfolio are modeled regularly.

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2001 are as follows:

	Principal Cash Flows	Weighted-Average Interest Rate
-----		
Fixed maturities and short-term investments:		
2002	\$ 37,038,816	3.84%
2003	19,700,000	5.74%
2004	24,025,000	5.79%
2005	28,632,768	5.91%
2006	48,879,557	5.83%
Thereafter	119,957,853	5.93%
-----		
Total	\$278,233,994	
=====		
Market value	\$284,732,437	
=====		
Debt		
2002	\$ 3,600,000	3.81%
2003	8,000,000	3.81%
2004	8,000,000	3.81%
2005	8,000,000	3.81%
-----		
Total	\$ 27,600,000	
=====		
Fair value	\$ 27,600,000	
=====		

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

EQUITY PRICE RISK

The Company's portfolio of equity securities, which is carried on the balance sheet at market value, has exposure to price risk. Price risk is defined as the potential loss in market value resulting from an adverse change in prices. Portfolio characteristics are analyzed regularly and market risk is actively managed through a variety of techniques. The portfolio is diversified across industries, and concentrations in any one company or industry are limited by parameters established by management.

The combined total of realized and unrealized equity investment losses were \$131,146, \$650,229, and \$394,931 in 2001, 2000, and 1999, respectively. During these three years the largest total equity investment gain and (loss) in a quarter was \$829,914 and \$(730,481), respectively.

## CONSOLIDATED BALANCE SHEETS

December 31,	2001	2000*
<b>ASSETS</b>		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value \$86,939,393 and \$144,662,436)	\$ 85,322,965	\$143,181,718
Available for sale, at fair value (amortized cost \$170,269,584 and \$114,524,472)	173,718,844	114,611,183
Equity securities, available for sale, at fair value (cost \$16,630,618 and \$12,500,558)	17,517,346	12,112,236
Short-term investments, at cost, which approximates fair value	24,074,200	19,439,505
<b>Total investments</b>	<b>300,633,355</b>	<b>289,344,642</b>
Cash	4,075,288	5,182,988
Accrued investment income	3,765,076	4,002,464
Premiums receivable	24,143,531	21,758,502
Reinsurance receivable	67,853,174	54,543,884
Deferred policy acquisition costs	13,604,215	12,284,214
Federal income taxes receivable	292,618	259,962
Deferred tax asset, net	7,474,730	7,690,886
Prepaid reinsurance premiums	29,593,467	24,712,384
Property and equipment, net	4,568,652	5,236,483
Accounts receivable-securities	50,023	234,817
Other	578,243	757,554
<b>Total assets</b>	<b>\$456,632,372</b>	<b>\$426,008,780</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities		
Losses and loss expenses	\$179,839,905	\$156,476,124
Unearned premiums	114,079,264	99,940,381
Accrued expenses	7,186,107	5,877,475
Reinsurance balances payable	839,156	1,634,975
Cash dividend declared to stockholders	869,877	797,282
Borrowings under line of credit	27,600,000	40,000,000
Accounts payable-securities	--	959,652
Due to affiliate	4,015,074	4,528,996
Other	1,274,640	1,664,304
<b>Total liabilities</b>	<b>335,704,023</b>	<b>311,879,189</b>
Stockholders' Equity		
Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued		
Common stock, \$1.00 par value, authorized 20,000,000 shares, issued 0 and 8,980,977 shares and outstanding 0 and 8,858,689 shares	--	8,980,977
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 6,097,214 and 0 shares and outstanding 6,015,690 and 0 shares	60,972	--
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 3,021,965 and 0 shares and outstanding 2,981,203 and 0 shares	30,220	--
Additional paid-in capital	58,887,715	46,969,840
Accumulated other comprehensive income (loss)	2,861,765	(199,063)
Retained earnings	59,979,425	59,269,593
Treasury stock, at cost	(891,748)	(891,756)
<b>Total stockholders' equity</b>	<b>120,928,349</b>	<b>114,129,591</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$456,632,372</b>	<b>\$426,008,780</b>

\*Restated - see note 1

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Year Ended December 31,	2001	2000*	1999*
<b>STATEMENTS OF INCOME</b>			
<b>Revenues</b>			
Net premiums earned (includes affiliated reinsurance of \$71,989,136, \$63,989,424 and \$60,234,261)	\$167,769,854	\$151,646,199	\$145,517,457
Investment income, net of investment expenses	15,885,544	16,394,747	13,590,695
Installment payment fees	1,587,396	1,532,792	1,456,918
Lease income	801,083	836,997	819,474
Service fees	--	--	393,494
Net realized investment gains (losses)	(880,254)	170,852	(38,702)
<b>Total revenues</b>	<b>185,163,623</b>	<b>170,581,587</b>	<b>161,739,336</b>
<b>Expenses</b>			
Net losses and loss expenses (includes affiliated reinsurance of \$50,283,481, \$36,767,436 and \$38,549,795)	118,177,549	104,383,176	100,080,616
Amortization of deferred policy acquisition costs	27,194,000	25,319,000	24,931,000
Other underwriting expenses	27,000,485	23,355,781	28,648,951
Policy dividends	1,691,759	1,330,330	1,341,294
Interest	2,247,465	3,285,036	1,535,249
Other	1,760,636	1,165,236	1,357,585
<b>Total expenses</b>	<b>178,071,894</b>	<b>158,838,559</b>	<b>157,894,695</b>
Income before income tax expense (benefit)	7,091,729	11,743,028	3,844,641
Income tax expense (benefit)	1,273,598	2,906,248	(2,950,556)
<b>Net income</b>	<b>\$ 5,818,131</b>	<b>\$ 8,836,780</b>	<b>\$ 6,795,197</b>
<b>Net income per common share</b>			
Basic	\$ .65	\$ 1.01	\$ .82
Diluted	\$ .64	\$ 1.01	\$ .82
<b>STATEMENTS OF COMPREHENSIVE INCOME</b>			
Net income	\$ 5,818,131	\$ 8,836,780	\$ 6,795,197
<b>Other comprehensive income (loss), net of tax</b>			
Unrealized gains (losses) on securities:			
Unrealized holding gain (loss) arising during the period, net of income tax expense (benefit) of \$1,277,504, \$1,057,179, and \$(1,804,294)	2,479,860	2,020,267	(3,459,669)
Reclassification adjustment for (gains) losses included in net income, net of income tax expense (benefit) of \$(299,286), \$58,090, and \$(13,159)	580,968	(112,762)	25,543
<b>Other comprehensive income (loss)</b>	<b>3,060,828</b>	<b>1,907,505</b>	<b>(3,434,126)</b>
<b>Comprehensive income</b>	<b>\$ 8,878,959</b>	<b>\$ 10,744,285</b>	<b>\$ 3,361,071</b>

\*Restated - see note 1

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock					
	Prior Shares	Class A Shares	Class B Shares	Prior Amount	Class A Amount	Class B Amount
Balance, January 1, 1999*	8,325,221			\$8,325,221	\$	\$
Issuance of common stock	248,989			248,989		
Net income						
Other comprehensive loss						
Cash dividends						
Balance, December 31, 1999*	8,574,210			\$8,574,210	\$	\$
Issuance of common stock	406,767			406,767		
Net income						
Other comprehensive income						
Grant of stock options						
Cash dividends						
Balance, December 31, 2000*	8,980,977			\$8,980,977	\$	\$
Issuance of common stock	61,830	60,144	3,758	61,830	601	38
Recapitalization	(9,042,807)	6,027,975	3,013,987	(9,042,807)	60,280	30,140
Net income						
Cash dividends						
Exercise of stock options		9,095	4,220		91	42
Grant of stock options						
Other comprehensive income						
Balance, December 31, 2001	--	6,097,214	3,021,965	\$ --	\$60,972	\$30,220

	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, January 1, 1999*	\$42,330,011	\$ 1,327,558	\$49,824,144	\$(891,756)	\$100,915,178
Issuance of common stock	2,265,426				2,514,415
Net income			6,795,197		6,795,197
Other comprehensive loss		(3,434,126)			(3,434,126)
Cash dividends			(2,998,330)		(2,998,330)
Balance, December 31, 1999*	\$44,595,437	\$(2,106,568)	\$53,621,011	\$(891,756)	\$103,792,334
Issuance of common stock	2,349,773				2,756,540
Net income			8,836,780		8,836,780
Other comprehensive income		1,907,505			1,907,505
Grant of stock options	24,630		(24,630)		--
Cash dividends			(3,163,568)		(3,163,568)
Balance, December 31, 2000*	\$46,969,840	\$ (199,063)	\$59,269,593	\$(891,756)	\$114,129,591
Issuance of common stock	1,200,202				1,262,671
Recapitalization	8,949,361			8	(3,018)
Net income			5,818,131		5,818,131
Cash dividends			(3,466,947)		(3,466,947)
Exercise of stock options	126,960				127,093
Grant of stock options	1,641,352		(1,641,352)		--
Other comprehensive income		3,060,828			3,060,828
Balance, December 31, 2001	\$58,887,715	\$ 2,861,765	\$59,979,425	\$(891,748)	\$120,928,349

\*Restated - see note 1

See accompanying notes to consolidated financial statements.



Donegal Group Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31,	2001	2000	1999
<b>Cash Flows from Operating Activities:</b>			
Net income	\$ 5,818,131	\$ 8,836,780	\$ 6,795,197
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,127,510	982,926	1,078,594
Realized investment (gains) losses	880,254	(170,852)	38,702
Changes in Assets and Liabilities, net of acquisition:			
Losses and loss expenses	23,363,781	12,296,118	7,452,899
Unearned premiums	14,138,883	7,788,243	2,395,965
Accrued expenses	1,308,632	(165,997)	1,166,287
Premiums receivable	(2,385,029)	(3,296,815)	1,477,671
Deferred policy acquisition costs	(1,320,001)	(316,463)	64,545
Deferred income taxes	(1,360,633)	499,976	(3,783,354)
Reinsurance receivable	(13,309,290)	(8,970,330)	(3,809,600)
Accrued investment income	237,388	(455,059)	(311,975)
Amounts due to/from affiliate	(513,922)	350,639	(1,133,037)
Reinsurance balances payable	(795,819)	262,686	(499,423)
Prepaid reinsurance premiums	(4,881,083)	(3,156,232)	(4,041,033)
Current income taxes	(32,656)	374,620	(388,577)
Change in pooling participation	--	3,322,031	--
Other, net	(271,364)	268,316	508,807
Net adjustments	16,186,651	9,613,807	216,471
Net cash provided by operating activities	22,004,782	18,450,587	7,011,668
<b>Cash Flows from Investing Activities:</b>			
Purchase of fixed maturities			
Held to maturity	(45,201,470)	(17,340,175)	(23,782,305)
Available for sale	(71,700,918)	(30,355,507)	(32,890,963)
Purchase of equity securities	(12,440,994)	(28,286,533)	(14,258,861)
Sale of fixed maturities			
Available for sale	16,250,109	8,719,165	503,895
Maturity of fixed maturities			
Held to maturity	51,313,296	13,490,715	15,563,638
Available for sale	50,781,533	11,928,622	19,049,880
Sale of equity securities	7,089,532	24,572,288	11,767,268
Sale of Atlantic Insurance Services, net	--	--	(48,810)
Net purchase of property and equipment	(161,269)	(275,982)	(461,669)
Net sales (purchases) of short-term investments	(4,634,695)	(2,850,343)	14,619,107
Net cash used in investing activities	(8,704,876)	(20,397,750)	(9,938,820)
<b>Cash Flows from Financing Activities:</b>			
Issuance of common stock	1,386,746	2,756,540	2,514,415
Borrowings (payments) under line of credit, net	(12,400,000)	3,000,000	(500,000)
Cash dividends paid	(3,394,352)	(3,126,959)	(2,946,170)
Net cash provided by (used in) financing activities	(14,407,606)	2,629,581	(931,755)
Net increase (decrease) in cash	(1,107,700)	682,418	(3,858,907)
Cash at beginning of year	5,182,988	4,500,570	8,359,477
Cash at end of year	\$ 4,075,288	\$ 5,182,988	\$ 4,500,570

\*Restated - see note 1  
See accompanying notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### ORGANIZATION AND BUSINESS

Donegal Group Inc. (the "Company") was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") and operates in the Mid-Atlantic and Southern states through its wholly owned stock insurance companies, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Southern Heritage Insurance Company ("Southern Heritage") and Pioneer Insurance Company of Ohio ("Pioneer-Ohio") (collectively "Insurance Subsidiaries"). The Company has three operating segments: the investment function, the personal lines of insurance and the commercial lines of insurance. Products offered in the personal lines of insurance consist primarily of homeowners and private passenger automobile policies. Products offered in the commercial lines of insurance consist primarily of commercial automobile, commercial multiple peril and workers' compensation policies. The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 70% of the pooled business (65% prior to July 1, 2000). Southern cedes 50% of its business to the Mutual Company. At December 31, 2001, the Mutual Company held 63% of the outstanding common stock of the Company.

In addition to the Company's Insurance Subsidiaries, it also owned all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), an insurance services organization. The Company sold all of the stock of AIS on October 1, 1999.

During 2000, the Company acquired 45% of the outstanding stock of Donegal Financial Services Corporation ("DFSC"), a bank holding company, for \$3,042,000 in cash. The remaining 55% of the outstanding stock of DFSC is owned by the Mutual Company.

On January 3, 2001, the Company announced that it had purchased all of the outstanding stock of Pioneer Insurance Company of New York ("Pioneer-New York") from the Mutual Company effective January 1, 2001. The purchase price was \$4,441,311, representing Pioneer-New York's adjusted statutory equity at December 31, 2000. The acquisition has been accounted for as a reorganization of entities under common control, similar to a pooling of interests, as both Pioneer-New York and the Company are under the common management and control of the Mutual Company. As such, the Company's financial statements have been restated to include Pioneer-New York as a consolidated subsidiary. In connection with the transaction, the Company issued the Mutual Company a \$4,441,311 note, which bears a 6% rate and is due in January 2003. The Company classifies this note in Due to Affiliate.

Delaware Atlantic Insurance Company ("Delaware"), previously a wholly owned subsidiary, and Pioneer-New York were merged into Atlantic States Insurance Company on August 1, 2001 and September 30, 2001, respectively. The mergers were accounted for as statutory mergers and had no financial impact on the consolidated entity.

#### BASIS OF CONSOLIDATION

The consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, include the accounts of Donegal Group Inc. and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The term "Company" as used herein refers to the consolidated entity.

#### USE OF ESTIMATES

In preparing the consolidated financial statements, management is required to make 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.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the liabilities for losses and loss expenses. While management uses available information to provide for such liabilities, future changes to these liabilities may be necessary based on changes in trends in claim frequency and severity.

#### INVESTMENTS

The Company classifies its debt and equity securities into the following categories:

Held to Maturity--Debt securities that the Company has 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.

If there is a decline in fair value below amortized cost which is other than temporary, the cost basis for such investments in the held to maturity and available for sale categories is reduced to fair value. Such decline in cost basis is recognized as a realized loss and charged to income.



Premiums and discounts on debt securities are amortized over the life of the security as an adjustment to yield using the effective interest method. Realized investment gains and losses are computed using the specific identification method.

Premiums and discounts for mortgage-backed debt securities are amortized using anticipated prepayments.

#### FAIR VALUES OF FINANCIAL INSTRUMENTS

The Company has used the following methods and assumptions in estimating its fair value disclosures:

Investments--Fair values for fixed maturity securities are based on quoted market prices, when available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or values obtained from independent pricing services through a bank trustee. The fair values for equity securities are based on quoted market prices.

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.

Borrowings Under Line of Credit--The carrying amounts reported in the balance sheet for the line of credit approximate fair value due to the variable rate nature of the line of credit.

#### REVENUE RECOGNITION

Insurance premiums are recognized as income over the terms of the policies. Unearned premiums are calculated on a daily pro-rata basis.

#### POLICY ACQUISITION COSTS

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other variable underwriting costs, are deferred and amortized over the period in which the premiums are earned. Anticipated losses and loss expenses, expenses for maintenance of policies in force and anticipated investment income are considered in the determination of the recoverability of deferred acquisition costs.

#### PROPERTY AND EQUIPMENT

Property and equipment are reported at depreciated cost that is computed using the straight-line method based upon estimated useful lives of the assets.

#### LOSSES AND LOSS EXPENSES

The liability for losses and loss expenses includes amounts determined on the basis of estimates for losses reported prior to the close of the accounting period and other estimates, including those for incurred but not reported losses and salvage and subrogation recoveries.

These liabilities are continuously reviewed and updated by management, and management believes that such liabilities are adequate to cover the ultimate net cost of claims and expenses. When management determines that changes in estimates are required, such changes are included in current earnings.

The Company has no material exposures to environmental liabilities.

#### INCOME TAXES

The Company and its subsidiaries currently file a consolidated federal income tax return.

The Company accounts 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 the Company's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled.

#### CREDIT RISK

The Company provides property and liability coverages through its Insurance Subsidiaries' independent agency systems located throughout its operating area. The majority of this business is billed directly to the insured, although a portion of the Company's commercial business is billed through its agents, who are extended credit in the normal course of business.

The Company's Insurance Subsidiaries have reinsurance agreements in place with the Mutual Company and with a number of other authorized reinsurers with at least an A.M. Best rating of A- or an equivalent financial condition.

The Company relies upon reinsurance agreements to limit its maximum net loss from large single risks or risks in concentrated areas, and to increase its capacity to write insurance. Reinsurance does not relieve the primary insurer from liability to its policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable under the terms of a reinsurance agreement, the Company is exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, the Company requires all of its reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition which, in the opinion of management, is equivalent to a company with at least an A- rating.

## STOCK-BASED COMPENSATION

Effective July 1, 2000, the Company adopted Financial Accounting Standards Board 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 Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation." FIN No. 44 states that APB Opinion No. 25 does not apply in the separate financial statements of a subsidiary to the accounting for stock 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 stock compensation, the entity granting the stock compensation should measure the fair value of the award at the grant date and recognize that fair value as a dividend to the controlling entity. These provisions apply to the Company, as the Mutual Company is the employer of record for all employees that provide services to the Company.

Prior to July 1, 2000, the Company's stock-based compensation plans were accounted for under the provisions of APB Opinion No. 25 and related interpretations. As such, compensation expense was recorded on the date of stock option grant only if the current market price of the underlying stock exceeded the exercise price. Additionally, the Company provides the pro-forma net income and earnings per share disclosures required by Statement of Financial Accounting Standards (SFAS No. 123), "Accounting for Stock-Based Compensation," for grants prior to the adoption of FIN No. 44.

## EARNINGS PER SHARE

Basic earnings per share are calculated 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.

## RECLASSIFICATIONS

Certain amounts in these financial statements have been reclassified from those previously presented. Gross and ceded premiums earned and losses and loss expenses are no longer presented in the statements of income. Reinsurance receivable, prepaid reinsurance premiums, unearned premiums, and the liabilities for losses and loss expenses have been reduced in the consolidated balance sheet as they no longer include the amounts under the agreements discussed in the last paragraph of note 2a. The amounts in note 6 as well as the consolidated statements of cash flows have been revised to conform to the changes in the consolidated balance sheets. Note 2a has been expanded to include the purpose of the various agreements and to separately disclose amounts under the various arrangements versus the aggregate disclosure previously provided. These reclassifications had no effect on total revenues, total expenses, net income, net income per share, cash flows provided by operating activities, or stockholders' equity.

## 2--TRANSACTIONS WITH AFFILIATES

The Company conducts business and has various agreements with the Mutual Company which are described below:

### A. REINSURANCE POOLING AND OTHER REINSURANCE ARRANGEMENTS

Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 70% (65% prior to July 1, 2000) of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed by the Mutual Company from Southern and Delaware (prior to January 1, 2000). The Mutual Company and Atlantic States write business with different risk profiles. Through the pooling arrangement, each is able to share proportionately in the results of all policies written by the other. Atlantic States ceded premiums earned of \$37,345,259, \$30,414,395 and \$23,745,989 and ceded losses and loss expenses incurred of \$29,094,804, \$22,966,106 and \$15,625,894 under this arrangement during 2001, 2000 and 1999, respectively. It also assumed premiums earned of \$126,769,521, \$110,943,962 and \$101,017,767 and assumed losses and loss expenses incurred of \$93,470,958, \$75,007,089 and \$68,563,183 under this arrangement during 2001, 2000 and 1999, respectively. Atlantic States had prepaid reinsurance premiums of \$20,942,093, \$16,251,612 and \$12,978,863 and a ceded liability for losses and loss expenses of \$39,321,214, \$31,068,101 and \$24,025,502 under this arrangement as of December 31, 2001, 2000 and 1999, respectively. It also had assumed unearned premiums of \$63,636,858, \$54,578,621 and \$46,283,485 and an assumed liability for losses and loss expenses of \$99,664,285, \$84,805,937 and \$80,258,589 under this arrangement at December 31, 2001, 2000 and 1999, respectively.

The Mutual Company and Southern have a quota share agreement whereby Southern cedes 50% of its direct business, less reinsurance, to the Mutual Company. The business assumed by the Mutual Company from Southern becomes part of the pooling arrangement between the Mutual Company and Atlantic States. Southern ceded premiums earned of \$14,995,606, \$14,413,261 and \$13,517,603 and ceded losses and loss expenses incurred of \$9,898,422, \$9,885,436 and \$9,986,718 under this agreement during 2001, 2000 and 1999, respectively. Southern had prepaid reinsurance premiums of \$7,310,471, \$7,084,729 and \$6,683,001 and a ceded liability for losses and loss expenses of \$10,068,604, \$7,924,750 and

\$7,054,012 under this agreement at December 31, 2001, 2000 and 1999, respectively. This agreement was terminated as of January 1, 2002.

Atlantic States, Southern, Pioneer-Ohio and Southern Heritage each have a catastrophe reinsurance agreement with the Mutual Company which limits the maximum liability under any one catastrophic occurrence to \$400,000, \$300,000, \$200,000 and \$400,000 (effective January 1, 2000), respectively, and \$1,000,000 (\$700,000 in 1999) for a catastrophe involving more than one of the companies. Prior to merging into Atlantic States, Delaware and Pioneer-New York each had a catastrophe reinsurance agreement with the Mutual Company which limited the maximum liability under any one catastrophic occurrence to \$300,000 and \$400,000, respectively. Prior to merging into Atlantic States, Delaware and the Mutual Company had an excess of loss reinsurance agreement in

which the Mutual Company assumed up to \$250,000 of losses in excess of \$50,000 and prior to January 1, 2000, a workers' compensation quota share agreement whereby Delaware ceded 70% of that business. The Mutual Company and Pioneer-Ohio have an excess of loss reinsurance agreement in which the Mutual Company assumes up to \$250,000 (\$200,000 in 2000 and 1999) of losses in excess of \$50,000. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to \$50,000 (\$25,000 in 2000 and 1999) of losses in excess of \$100,000. Prior to merging into Atlantic States, Pioneer-New York and the Mutual Company had an excess of loss reinsurance agreement in which the Mutual Company assumed up to \$250,000 (\$200,000 in 2000 and 1999) of losses in excess of \$50,000. Effective October 1, 2000 the Mutual Company and Southern Heritage have an excess of loss reinsurance agreement in which the Mutual Company assumed up to \$175,000 (\$125,000 in 2000) of losses in excess of \$125,000. The Mutual Company has agreements in place with Southern and Pioneer-Ohio (and Delaware prior to merging into Atlantic States) to reallocate the loss results of workers' compensation business written by those companies as part of commercial accounts primarily written by the Mutual Company or Atlantic States. These agreements provide for the workers' compensation loss ratios of each company to be no worse than the average workers' compensation loss ratio for all of the companies combined. The Mutual Company and Pioneer-New York also had an aggregate excess of loss reinsurance agreement, entered into as part of the sale of Pioneer-New York from the Mutual Company to Donegal Group Inc., in which the Mutual Company agreed to assume the adverse loss development of claims with dates of loss prior to December 31, 2000, as developed through December 31, 2002, and to assume losses in excess of a 60% loss ratio through December 31, 2002. The subsidiaries ceded premiums earned of \$2,439,520, \$2,126,882 and \$3,519,914 and ceded losses and loss expenses incurred of \$4,194,251, \$5,388,111 and \$4,400,776 under these various agreements during 2001, 2000 and 1999, respectively. The subsidiaries had prepaid reinsurance premiums of \$0, \$0 and \$733,183 and a ceded liability for losses and loss expenses of \$5,395,528, \$4,941,116 and \$2,689,825 under these various agreements at December 31, 2001, 2000, and 1999, respectively.

Southern, Pioneer-Ohio and Southern Heritage (and Delaware and Pioneer-New York prior to merging into Atlantic States) each have agreements with the Mutual Company under which they cede, and then reassume back, 100% of their business net of reinsurance. The primary purpose of the agreements is to provide these subsidiaries with the same A.M. Best rating (currently "A") as the Mutual Company, which these subsidiaries could not achieve without these contracts in place. These agreements do not transfer insurance risk. While these subsidiaries ceded and reassumed amounts received from policyholders of \$41,142,936, \$25,790,126 and \$22,486,490 and claims of \$23,348,952, \$15,325,638 and \$13,177,186 under these agreements in 2001, 2000 and 1999, respectively, the amounts are not reflected in the consolidated financial statements. The aggregate liabilities ceded and reassumed under these agreements were \$36,494,487 and \$26,572,959 at December 31, 2001, and 2000, respectively.

#### B. EXPENSE SHARING

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled \$29,298,569, \$26,985,080 and \$27,466,898 for 2001, 2000 and 1999, respectively.

#### C. LEASE AGREEMENT

The Company leases office equipment and automobiles to the Mutual Company under a 10-year lease dated January 1, 2000.

#### D. LEGAL SERVICES

Donald H. Nikolaus, President and a director of the Company, is also a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as general counsel to the Company since 1986, principally in connection with the defense of claims litigation arising in Lancaster, Dauphin and York counties. Such firm is paid its customary fees for such services.

#### E. PROVINCE BANK

As of December 31, 2001, the Company had \$3,585,566 in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. The Company earned \$6,350 in interest on these accounts during 2001.

#### 3--INVESTMENTS

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2001 and 2000, are as follows:

2001				
HELD TO MATURITY	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities				

and obligations of U.S. government corporations and agencies	\$23,808,841	\$ 336,288	\$ 27,500	\$ 24,117,629
Canadian government obligation	498,894	36,106	--	535,000
Obligations of states and political subdivisions	24,981,562	690,700	53,312	25,618,950
Corporate securities	27,423,039	659,961	121,021	27,961,979
Mortgage-backed securities	8,610,629	113,541	18,335	8,705,835
-----				
Totals	\$85,322,965	\$1,836,596	\$ 220,168	\$ 86,939,393
=====				

2001

AVAILABLE FOR SALE	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 67,468,897	\$1,755,874	\$ 249,306	\$ 68,975,465
Obligations of states and political subdivisions	53,962,895	1,269,340	85,535	55,146,700
Corporate securities	34,094,195	828,344	115,939	34,806,600
Mortgage-backed securities	14,743,597	78,666	32,184	14,790,079
Equity securities	16,630,618	1,270,239	383,511	17,517,346
Totals	\$186,900,202	\$5,202,463	\$866,475	\$191,236,190

2000

HELD TO MATURITY	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 38,779,230	\$ 343,819	\$ 255,049	\$ 38,868,000
Canadian government obligation	498,559	11,441	--	510,000
Obligations of states and political subdivisions	66,831,090	1,499,955	45,904	68,285,141
Corporate securities	21,621,472	228,851	195,287	21,655,036
Mortgage-backed securities	15,451,367	47,120	154,228	15,344,259
Totals	\$143,181,718	\$2,131,186	\$ 650,468	\$144,662,436

2000

AVAILABLE FOR SALE	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 68,007,634	\$ 544,135	\$ 650,339	\$ 67,901,430
Obligations of states and political subdivisions	17,965,179	327,256	36,885	18,255,550
Corporate securities	22,902,588	312,426	306,664	22,908,350
Mortgage-backed securities	5,649,071	14,790	118,008	5,545,853
Equity securities	12,500,558	880,419	1,268,741	12,112,236
Totals	\$127,025,030	\$2,079,026	\$2,380,637	\$126,723,419

The amortized cost and estimated fair value of fixed maturities at December 31, 2001, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

Estimated

	Amortized Cost	Fair Value
HELD TO MATURITY		
Due in one year or less	\$ 1,000,081	\$ 1,012,500
Due after one year through five years	33,277,659	33,857,210
Due after five years through ten years	38,671,342	39,626,349
Due after ten years	3,763,254	3,737,500
Mortgage-backed securities	8,610,629	8,705,834
Total held to maturity	\$ 85,322,965	\$ 86,939,393
AVAILABLE FOR SALE		
Due in one year or less	\$ 11,815,944	\$ 12,046,000
Due after one year through five years	79,085,686	81,151,668
Due after five years through ten years	56,670,691	57,971,097
Due after ten years	7,953,666	7,760,000
Mortgage-backed securities	14,743,597	14,790,079
Total available for sale	\$170,269,584	\$173,718,844

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2001 and 2000, amounted to \$5,667,959 and \$6,056,374, respectively.

Net investment income of the Company, consisting primarily of interest and dividends, is attributable to the following sources:

	2001	2000	1999
Fixed maturities	\$15,145,949	\$15,180,008	\$13,046,603
Equity securities	546,243	635,049	440,268
Short-term investments	920,538	1,221,724	809,949
Other	255,250	255,250	316,139
Investment income	16,867,980	17,292,031	14,612,959
Investment expenses	982,436	897,284	1,022,264
Net investment income	\$15,885,544	\$16,394,747	\$13,590,695

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:

	2001	2000	1999
Gross realized gains:			
Fixed maturities	\$ 554,560	\$ 237,748	\$ --
Equity securities	323,451	1,813,242	586,745
	878,011	2,050,990	586,745
Gross realized losses:			
Fixed maturities	28,618	20,597	6,083
Equity securities	1,729,647	1,859,541	619,364
	1,758,265	1,880,138	625,447
Net realized gains (losses)	\$ (880,254)	\$ 170,852	\$ (38,702)
Change in difference between fair value and cost of investments:			
Fixed maturities	\$ 3,498,259	\$ 7,300,279	\$(11,668,991)
Equity securities	1,275,050	(603,930)	(362,312)
	\$ 4,773,309	\$ 6,696,349	\$(12,031,303)



Income taxes (benefit) on realized investment gains (losses) were \$(299,286), \$58,090, and \$(13,159) for 2001, 2000 and 1999, respectively. Deferred income taxes (benefits) applicable to net unrealized investment gains (losses) included in shareholders' equity were \$1,474,242 and \$(102,548) at December 31, 2001 and 2000, respectively.

During 2001 and 2000, certain investments trading below cost had declined on an other-than-temporary basis. Losses of \$1,462,913 and \$436,943 were included in net realized investment gains (losses) for these investments in 2001 and 2000, respectively.

The Company has no derivative instruments or hedging activities. On January 1, 2001, the Company transferred investments with an amortized cost of \$51,640,154 and fair value of \$52,444,675 from the held to maturity classification to the available for sale classification under the provisions of SFAS No. 133 and 138. The unrealized holding gain of \$804,521 at January 1, 2001 was reported in other comprehensive income. The transfer had no impact on net income.

#### 4--DEFERRED POLICY ACQUISITION COSTS

Changes in deferred policy acquisition costs are as follows:

	2001	2000	1999
Balance, January 1	\$12,284,214	\$11,445,572	\$11,510,117
Acquisition costs deferred	28,514,001	26,157,642	24,866,455
Amortization charged to earnings	27,194,000	25,319,000	24,931,000
Balance, December 31	\$13,604,215	\$12,284,214	\$11,445,572

#### 5--PROPERTY AND EQUIPMENT

Property and equipment at December 31, 2001 and 2000, consisted of the following:

	2001	2000	Estimated Useful Life
Cost--office equipment	\$5,012,290	\$4,981,970	5-15 years
automobiles	992,412	947,865	3 years
real estate	3,063,646	3,063,646	15-50 years
software	561,146	561,146	5 years
Accumulated depreciation	(9,629,494) (5,060,842)	9,554,627 (4,318,144)	
	\$4,568,652	\$5,236,483	

Depreciation expense for 2001, 2000, and 1999 amounted to \$829,100, \$899,750 and \$970,331, respectively.

#### 6--LIABILITY FOR LOSSES AND LOSS EXPENSES

Activity in the liability for losses and loss expenses is summarized as follows:

	2001	2000	1999
Balance at January 1	\$156,476,124	\$144,180,006	\$136,727,107
Less reinsurance recoverable	53,766,710	44,945,908	40,712,330
Net balance at January 1	102,709,414	99,234,098	96,014,777
Incurred related to:			
Current year	110,142,467	103,671,401	100,573,192
Prior years	8,035,082	711,775	(492,576)
Total incurred	118,177,549	104,383,176	100,080,616
Paid related to:			
Current year	63,289,736	61,848,261	59,434,306
Prior years	43,053,112	39,059,599	37,426,989
Total paid	106,342,848	100,907,860	96,861,295
Net balance at December 31	114,544,115	102,709,414	99,234,098
Plus reinsurance recoverable	65,295,790	53,766,710	44,945,908
Balance at December 31	\$179,839,905	\$156,476,124	\$144,180,006

The Company recognized an increase (decrease) in the liability for losses and loss expenses of prior years of \$8.0 million, \$0.7 million and \$(0.5 million) in 2001, 2000 and 1999, respectively. These developments are primarily attributable to variations from expected claim severity in the private passenger

and commercial automobile liability, workers' compensation and commercial multiple peril lines of business.

#### 7--LINE OF CREDIT

At December 31, 2001 and 2000, pursuant to a credit agreement dated December 29, 1995, and amended as of July 27, 1998, with Fleet National Bank, the Company had unsecured borrowings of \$27.6 million and \$40 million, respectively. Such borrowings were made in connection with the acquisitions of Delaware, Pioneer-Ohio, and Southern Heritage and various capital contributions to the subsidiaries. As of December 31, 2001, the Company may borrow up to \$32 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 2001, the interest rates were 4.75% on an outstanding prime rate balance of \$2.6 million, 3.825% on an outstanding Eurodollar rate balance of \$10 million and 3.6375% on another Eurodollar rate balance of \$15 million. In addition, the Company pays a rate of 3/10 of 1% per annum on the average daily unused portion of the bank's commitment. On each July 27, the credit line is reduced by \$8 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

## 8--REINSURERS

## UNAFFILIATED REINSURERS

In addition to the primary reinsurance in place with the Mutual Company, the Insurance Subsidiaries have other reinsurance in place, principally with four unaffiliated reinsurers. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2001, 2000 and 1999:

	2001	2000	1999
Premiums written	\$ 9,348,853	\$ 8,241,416	\$ 8,391,805
Premiums earned	\$ 9,440,035	\$ 8,026,478	\$ 8,549,509
Losses and loss expenses	\$ 6,907,947	\$ 3,027,810	\$ 5,537,410
Prepaid reinsurance premiums	\$ 1,340,903	\$ 1,376,043	\$ 1,161,105
Liability for losses and loss expenses	\$10,510,444	\$ 9,832,743	\$11,176,569

## TOTAL REINSURANCE

The following amounts represent the total of all ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2001, 2000, and 1999:

	2001	2000	1999
Premiums earned	\$64,220,420	\$54,981,016	\$49,333,015
Losses and loss expenses	\$50,095,424	\$41,267,463	\$35,550,798
Prepaid reinsurance premiums	\$29,593,467	\$24,712,384	\$21,556,152
Liability for losses and loss expenses	\$65,295,790	\$53,766,710	\$44,945,908

The following amounts represent the effect of reinsurance on premiums written for 2001, 2000, and 1999:

	2001	2000	1999
Direct	\$110,298,533	\$ 99,042,235	\$ 91,854,011
Assumed	135,830,624	119,217,433	105,392,426
Ceded	69,101,503	58,137,248	53,374,048
Net premiums written	\$177,027,654	\$160,122,420	\$143,872,389

The following amounts represent the effect of reinsurance on premiums earned for 2001, 2000, and 1999:

	2001	2000	1999
Direct	\$105,214,059	\$ 95,671,588	\$ 93,399,834
Assumed	126,776,215	110,955,627	101,450,638
Ceded	64,220,420	54,981,016	49,333,015
Net premiums earned	\$167,769,854	\$151,646,199	\$145,517,457

## 9--INCOME TAXES

The provision for income tax consists of the following:

	2001	2000	1999
Current	\$ 2,634,231	\$ 2,406,272	\$ 832,798
Deferred	(1,360,633)	499,976	(3,783,354)
Federal tax provision	\$ 1,273,598	\$ 2,906,248	\$(2,950,556)

The effective tax rate is different than the amount computed at the statutory federal rate of 34% for 2001, 2000 and 1999. The reason for such difference and the related tax effect are as follows:

	2001	2000	1999
Income before income taxes	\$7,091,729	\$11,743,028	\$ 3,844,641
Computed "expected" taxes at 34%	2,411,188	3,992,630	1,307,178
Recognition of net operating loss carryover of Southern Heritage	--	--	(3,004,524)
Tax-exempt interest	(1,399,238)	(1,347,959)	(1,355,816)
Dividends received deduction	(21,908)	(25,423)	(83,948)
Other, net	283,556	287,000	186,554

Federal income tax provision	\$1,273,598	\$ 2,906,248	\$(2,950,556)
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The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2001 and 2000, are as follows:

	2001	2000
<b>Deferred tax assets:</b>		
Unearned premium	\$ 5,778,529	\$ 5,139,217
Loss reserves	5,433,005	4,878,850
Net operating loss carryforward - Southern Heritage	2,032,094	2,339,133
Unrealized loss	--	102,548
Other	1,013,899	174,886
<b>Total</b>	<b>\$14,257,527</b>	<b>\$12,634,634</b>
<b>Deferred tax liabilities:</b>		
Depreciation expense	\$ 379,594	\$ 464,235
Deferred policy acquisition costs	4,625,433	4,176,632
Salvage recoverable	303,528	302,881
Unrealized gain	1,474,242	--
<b>Total</b>	<b>\$ 6,782,797</b>	<b>\$ 4,943,748</b>
<b>Net deferred tax assets</b>	<b>\$ 7,474,730</b>	<b>\$ 7,690,886</b>

A valuation allowance is provided when it is more likely than not that some portion of the tax asset will not be realized. Management has determined that it is not required to establish a valuation allowance for any deferred tax asset at December 31, 2001, since it is more likely than not that the deferred tax assets will be realized through reversals of existing temporary differences, future taxable income, carryback to taxable income in prior years and the implementation of tax planning strategies.

A change in the federal income laws was enacted during 1999 which allows net operating loss carryforwards of an acquired company to be used to offset future taxable income of other affiliated companies filing as part of a consolidated tax return. Prior law allowed such net operating loss carryforward to be used to offset taxable income of the acquired company only. Due to this law change, the net operating loss carryforward, obtained as part of the acquisition of Southern Heritage, can now be used to offset taxable income generated by the other consolidated affiliates. This was the primary factor in management's determination that no valuation allowance was required at the end of 1999. Accordingly, the tax benefit of this carryforward, as adjusted for the 1998 tax return as filed, of \$3,004,524 was recognized in 1999.

At December 31, 2001, the Company has a net operating loss carryforward of \$5,976,747, which is available to offset taxable income of the Company. Such net operating loss carryforward will expire beginning in 2009. Federal income tax laws limit the amount of net operating loss carryforward that the Company can use in any one year to approximately \$1 million.

#### 10--STOCKHOLDERS' EQUITY

On April 19, 2001 the Company's stockholders approved an amendment to the Company's Certificate of Incorporation. Among other things, the amendment reclassified the Company's common stock as Class B common stock and effected a one-for-three reverse split of the Company's 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. The Company's Board 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. The effect of the reverse split and the stock dividend taken together is that the Company had the same total number of shares outstanding after the reverse split and the stock dividend as it did before the reverse split and the stock dividend. Therefore, there is no change in the historical earnings per share of the Class A common stock and the Class B common stock after the reverse split and the stock dividend compared to before the reverse split and the stock dividend.

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 a merger or consolidation of the Company 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 any liquidation, dissolution or winding-up of the Company, any assets available to common stockholders will be distributed pro-rata to the holders of Class A and Class B common stock.

#### 11--STOCK COMPENSATION PLANS

##### EQUITY INCENTIVE PLANS

During 1996 the Company adopted an Equity Incentive Plan for key employees. During 2001 the Company adopted a nearly identical plan that made a total of 1,500,000 shares of Class A common stock available. Each plan provides for the granting of awards by the 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. The stock appreciation rights permit surrender of the option and receipt of the excess of current market price over option price in cash. No stock appreciation rights have been issued.

During 1996 the Company adopted an Equity Incentive Plan For Directors. During 2001 the Company adopted a nearly identical plan that made 200,000 shares of Class A common stock available. Awards may be made in the form of stock options, and the plan additionally provides for the issuance of 175 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2001, the Company has 76,112 unexercised options under these plans. Additionally 1,947, 1,947 and 2,124 shares of restricted stock were issued on January 2, 2001, 2000 and 1999, respectively.

All options issued prior to 2001 were converted to options on Class A and Class B common stock as a result of the Company's recapitalization. No further shares are available for plans in effect prior to 2001.

Information regarding activity in the Company's stock option plans is presented below:

	Number of Options	Weighted-Average Exercise Price Per Share
-----		
Outstanding at December 31, 1998	1,091,120	\$15.73
Granted - 1999	433,500	8.00
Exercised - 1999	--	--
Forfeited - 1999	28,227	15.52
-----		
Outstanding at December 31, 1999	1,496,393	\$13.50
Granted - 2000	59,500	8.05
Exercised - 2000	--	--
Forfeited - 2000	39,555	12.84
-----		
Outstanding at December 31, 2000	1,516,338	\$13.19
Granted - 2001	459,000	13.93
Exercised - 2001	13,315	8.00
Forfeited - 2001	27,556	13.50
-----		
Outstanding at December 31, 2001	1,934,467	\$13.27
=====		
Exercisable at:		
December 31, 1999	897,338	\$15.99
=====		
December 31, 2000	1,190,004	\$16.68
=====		

Options available for future grants at December 31, 2001 are 1,241,000.

The following table summarizes information about fixed stock options at December 31, 2001:

Exercise Price	Number of Options Outstanding	Weighted-Average Remaining Contractual Life	Number of Options Exercisable
\$ 8.00	457,685	3.0 years	305,123
\$ 9.00	9,500	4.5 years	2,000
\$13.50	524,448	0.1 years	524,448
\$14.00	452,500	4.5 years	-
\$18.00	490,334	1.25 years	490,334

#### EMPLOYEE STOCK PURCHASE PLANS

During 1996 the Company adopted an Employee Stock Purchase Plan. During 2001, the Company adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance.

The new 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 the Company's common stock on the last day before the first day of the enrollment period (June 1 and December 1) of the plan or 85% of the fair market value of the Company's common stock on the last day of the subscription period (June 30 and December 31). A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 1999	\$13.28125	10,227
July 1, 1999	\$ 9.66875	11,876
January 1, 2000	\$ 5.41875	23,906
July 1, 2000	\$ 4.88750	21,714
January 1, 2001	\$ 5.95000	16,438
July 1, 2001	\$ 8.71250	11,377

On January 1, 2002, the Company issued an additional 12,769 shares at a price of \$8.84850 per share under this plan.

#### AGENCY STOCK PURCHASE PLANS

On December 31, 1996, the Company adopted an Agency Stock Purchase Plan. During 2001, the Company adopted a nearly identical plan that made 300,000 shares of Class A common stock available for issuance. The plan provides for agents of affiliated companies of Donegal Group Inc. to invest up to \$12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period. During 2001, 2000 and 1999, 16,557, 46,603, and 47,841 shares, respectively, were issued under this plan. Expense recognized under the plan was not material.

#### PRO-FORMA DISCLOSURES

The weighted-average grant date fair value of options granted for the various plans during 2000 and 1999 was \$2.23 and \$1.98, respectively.

The fair values above were calculated based upon risk-free interest rates of 5.75% for the Stock Purchase Plans and the Equity Incentive Plans, expected lives of 6 months for the Stock Purchase Plans and 5 years for the Equity Incentive Plans, expected volatility of 54% for 2000 and 47% for 1999, and an expected dividend yield of 4.5% for 2000 and 5.0% for 1999.

Through June 30, 2000, the Company applied APB Opinion No. 25 in accounting for its stock-based compensation plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and certain of its stock purchase plans. Had the Company recognized stock compensation expense in accordance with SFAS No. 123, net income and earnings per share would have been reduced to the pro-forma amounts shown below:

	2001	2000	1999
Net income:			
As reported	\$5,818,131	\$8,836,780	\$6,795,197
Pro-forma	5,617,773	8,071,825	5,595,851
Basic earnings per share:			
As reported	.65	1.01	.82
Pro-forma	.63	.92	.68
Diluted earnings per share:			
As reported	.64	1.01	.82
Pro-forma	.62	.92	.68

#### 12--STATUTORY NET INCOME, CAPITAL AND SURPLUS AND DIVIDEND RESTRICTIONS

The following is selected information, as filed with insurance regulatory authorities, for the Insurance Subsidiaries as determined in accordance with accounting practices prescribed or permitted by such insurance regulatory authorities (restated for mergers):

	2001	2000	1999
ATLANTIC STATES			
Statutory capital and surplus	\$ 86,124,896	\$ 88,620,380	\$ 82,401,227
Statutory unassigned surplus	\$ 44,464,032	\$ 46,959,516	\$ 40,740,363
Statutory net income (loss)	\$ (54,605)	\$ 8,134,135	\$ 4,832,737
SOUTHERN			
Statutory capital and surplus	\$ 10,863,481	\$ 9,082,587	\$ 7,293,856
Statutory unassigned surplus	\$ 5,761,211	\$ 3,980,317	\$ 2,191,586
Statutory net income	\$ 1,666,477	\$ 1,543,128	\$ 184,285

PIONEER-OHIO

Statutory capital and surplus	\$ 5,524,466	\$ 5,811,315	\$ 5,677,926
=====			
Statutory unassigned deficit	\$ (1,475,534)	\$ (1,188,685)	\$ (1,322,074)
=====			
Statutory net income	\$ (621,520)	\$ (176,011)	\$ 108,322
-----			
SOUTHERN HERITAGE			
Statutory capital and surplus	\$ 19,867,276	\$ 16,975,171	\$ 16,508,422
=====			
Statutory unassigned deficit	\$(12,648,039)	\$(15,540,144)	\$(16,006,893)
=====			
Statutory net income	\$ 3,514,487	\$ 1,486,698	\$ 487,098
=====			

The Company's principal source of cash for payment of dividends are dividends from its Insurance Subsidiaries which are required by law to maintain certain minimum capital and 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. Atlantic States, Southern, Pioneer-Ohio and Southern Heritage are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 2001, all four companies' statutory capital and surplus were substantially above the RBC requirements. Amounts available for distribution as dividends to Donegal Group Inc. without prior approval of insurance regulatory authorities in 2002 are \$8,612,490 from Atlantic States, \$1,086,348 from Southern, \$552,447 from Pioneer-Ohio and \$3,514,487 from Southern Heritage.

The National Association of Insurance Commissioners (NAIC) has adopted the Codification of Statutory Accounting Principles with an effective date of January 1, 2001. The codified principles are intended to provide a basis of accounting recognized and adhered to in the absence of conflict with, or silence of, state statutes and regulations. The impact of the codified principles on the statutory capital and surplus of the Company's Insurance Subsidiaries as of January 1, 2001 is as follows: Atlantic States - \$6,168,742 increase; Southern Heritage - \$1,083,354 increase; Pioneer-Ohio - \$313,638 increase; and Southern - \$1,171,204 increase.



13--RECONCILIATION OF STATUTORY FILINGS TO AMOUNTS REPORTED HEREIN

The Company's 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 generally accepted accounting principles.

Reconciliations of statutory net income and capital and surplus, as determined using statutory accounting principles, to the amounts included in the accompanying financial statements are as follows:

	Year Ended December 31,		
	2001	2000	1999
Statutory net income of Insurance Subsidiaries	\$ 4,504,839	\$10,987,950	\$ 5,612,442
Increases (decreases):			
Deferred policy acquisition costs	1,320,001	838,642	(64,545)
Deferred federal income taxes	1,360,633	(499,976)	3,783,354
Salvage and subrogation recoverable	155,088	305,918	(226,617)
Consolidating eliminations and adjustments	(13,783,695)	(4,318,624)	(1,387,864)
Parent-only net income (loss)	12,261,265	1,522,870	(908,987)
Non-insurance subsidiary net income (loss)	--	--	(12,586)
Net income as reported herein	\$ 5,818,131	\$ 8,836,780	\$ 6,795,197

	December 31,		
	2001	2000	1999
Statutory capital and surplus of Insurance Subsidiaries	\$122,380,119	\$120,489,453	\$111,881,431
Increases (decreases):			
Deferred policy acquisition costs	13,604,215	12,284,214	11,445,572
Deferred federal income taxes	(820,313)	7,690,886	9,221,874
Salvage and subrogation recoverable	8,197,948	8,042,860	7,736,942
Statutory reserves	--	2,623,921	5,154,062
Non-admitted assets and other adjustments, net	334,092	911,370	942,170
Fixed maturities	3,793,048	493,055	(2,968,655)
Consolidating eliminations and adjustments	(39,693,089)	(40,973,097)	(41,072,150)
Parent-only equity	13,132,329	2,566,929	1,451,088
Stockholders' equity as reported herein	\$120,928,349	\$114,129,591	\$103,792,334

14--SUPPLEMENTARY INFORMATION ON STATEMENT OF CASH FLOWS

The following reflects income taxes and interest paid during 2001, 2000 and 1999:

	2001	2000	1999
Income taxes	\$2,666,887	\$2,031,652	\$1,221,375
Interest	\$3,049,844	\$2,731,048	\$1,370,155

During 1999, the Company wrote off fixed assets with a net carrying value of \$407,000 which was a non-cash charge to earnings.

15--EARNINGS PER SHARE

The following information illustrates the computation of net income, outstanding shares and earnings per share on both a basic and diluted basis for the years ending December 31, 2001, 2000 and 1999:

	Net Income	Weighted-Average Shares Outstanding	Earnings Per Share
2001:			
Basic	\$5,818,131	8,941,781	.65
Effect of stock options	--	136,669	(.01)
Diluted	\$5,818,131	9,078,450	.64
2000:			
Basic	\$8,836,780	8,715,899	\$1.01

Effect of stock options	--	21,011	--
Diluted	\$8,836,780	8,736,910	\$1.01
1999:			
Basic	\$6,795,197	8,327,356	\$ .82
Effect of stock options	--	--	--
Diluted	\$6,795,197	8,327,356	\$ .82

The following options to purchase shares of common stock were not included in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price:

	2001	2000	1999
Options excluded from diluted earnings per share	1,467,282	1,045,338	1,496,393

## 16--CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

CONDENSED BALANCE SHEETS  
(\$ in thousands)

December 31,	2001	2000
<b>ASSETS</b>		
Investment in subsidiaries (equity method)	\$152,089	\$155,600
Cash	403	2,381
Property and equipment	1,623	1,997
Other	264	715
<b>Total assets</b>	<b>\$154,379</b>	<b>\$160,693</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Liabilities</b>		
Cash dividends declared to stockholders	\$ 870	\$ 797
Line of credit	27,600	40,000
Due to affiliate	4,441	4,441
Other	540	1,325
<b>Total liabilities</b>	<b>33,451</b>	<b>46,563</b>
<b>Stockholders' equity</b>	<b>120,928</b>	<b>114,130</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$154,379</b>	<b>\$160,693</b>

CONDENSED STATEMENTS OF INCOME  
(\$ in thousands)

Year Ended December 31,	2001	2000	1999
<b>Revenues</b>			
Dividends-subsiidiaries	\$14,419	\$3,900	\$ 820
Other	824	866	865
<b>Total revenues</b>	<b>15,243</b>	<b>4,766</b>	<b>1,685</b>
<b>Expenses</b>			
Operating expenses	1,761	1,165	938
Interest	2,288	3,304	2,463
<b>Total expenses</b>	<b>4,049</b>	<b>4,469</b>	<b>3,401</b>
Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries	11,194	297	(1,716)
Income tax benefit	(1,067)	(1,226)	(807)
Income (loss) before equity in undistributed net income (loss) of subsidiaries	12,261	1,523	(909)
Equity in undistributed net income (loss) of subsidiaries	(6,443)	7,314	7,704
<b>Net income</b>	<b>\$ 5,818</b>	<b>\$8,837</b>	<b>\$6,795</b>

CONDENSED STATEMENTS OF CASH FLOWS  
(\$ in thousands)

Year Ended December 31,	2001	2000	1999
<b>Cash flows from operating activities:</b>			
Net income	\$ 5,818	\$ 8,837	\$ 6,795
<b>Adjustments:</b>			
Equity in undistributed net loss (income) of subsidiaries	6,443	(7,314)	(7,704)
Other	252	1,123	2,365
<b>Net adjustments</b>	<b>6,695</b>	<b>(6,191)</b>	<b>(5,339)</b>
<b>Net cash provided</b>	<b>12,513</b>	<b>2,646</b>	<b>1,456</b>
<b>Cash flows from investing activities:</b>			
Net purchase of property and equipment	(122)	(262)	(426)
Sale of AIS	--	--	100
Investment in Donegal Financial Services Corp.	--	(3,042)	--
Other	38	38	(426)
<b>Net cash used</b>	<b>(84)</b>	<b>(3,266)</b>	<b>(752)</b>
<b>Cash flows from financing activities:</b>			
Cash dividends paid	(3,394)	(3,127)	(2,946)
Issuance of common stock	1,387	2,757	2,514

Line of credit, net	(12,400)	3,000	(500)
Net cash provided (used)	(14,407)	2,630	(932)
Net change in cash	(1,978)	2,010	(228)
Cash at beginning of year	2,381	371	599
Cash at end of year	\$ 403	\$ 2,381	\$ 371

17--SEGMENT INFORMATION

As an underwriter of property and casualty insurance, the Company has three reportable segments which consist of the investment function, the personal lines of insurance and the commercial lines of insurance. Using independent agents, the Company markets personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

The Company evaluates the performance of the personal lines and commercial lines primarily based upon underwriting results as determined under statutory accounting practices (SAP) for the total business of the Company.

Assets are not allocated to the personal and commercial lines and are reviewed in total by management for purposes of decision making. Donegal Group Inc. operates only in the United States and no single customer or agent provides 10 percent or more of revenues.

Financial data by segment is as follows:

	2001	2000	1999
	-----		
	(\$ in thousands)		
	-----		
Revenues:			
Premiums earned:			
Commercial lines	\$ 62,877	\$ 54,581	\$ 47,804
Personal lines	104,893	97,065	97,713
	-----		
Total premiums earned	167,770	151,646	145,517
	-----		
Net investment income	15,886	16,395	13,591
Realized investment gains (losses)	(880)	171	(39)
Other	2,388	2,370	2,670
	-----		
Total revenues	\$185,164	\$170,582	\$161,739
	=====		
Income before income taxes:			
Underwriting income (loss):			
Commercial lines	\$ (3,037)	\$ 763	\$ (839)
Personal lines	(5,090)	(4,649)	(8,461)
	-----		
SAP underwriting loss	(8,127)	(3,886)	(9,300)
GAAP adjustments	1,833	1,144	(184)
	-----		
GAAP underwriting loss	(6,294)	(2,742)	(9,484)
Net investment income	15,886	16,395	13,591
Realized investment gains (losses)	(880)	171	(39)
Other	(1,620)	(2,081)	(223)
	-----		
Income before income taxes	\$ 7,092	\$ 11,743	\$ 3,845
	=====		

18--RESTRUCTURING CHARGE

On September 29, 1999, the Company announced a plan to consolidate certain subsidiary support functions into its Marietta, Pennsylvania office. As a result of this consolidation, the Company recorded a restructuring charge of \$2,206,000 in 1999 for employee termination benefits, occupancy charges, lease cancellation costs, and asset impairments. The charge was included in other underwriting expenses. The consolidation was completed by the end of the first quarter of 2000.

Employee termination benefits of \$782,000 included severance payments, which were paid in a lump sum or over a defined period, and related benefits for approximately 60 employees. Of the terminated employees, approximately 50% were from subsidiary support functions and approximately 50% were from the Marietta, Pennsylvania office. By December 31, 1999, all of the terminated employees had left the employment of the Company.

Included in occupancy charges of \$488,000 were future lease obligations, less anticipated sublease benefits, for leased space which is no longer used by the Delaware and Southern Heritage subsidiary support functions.

Also included in the restructuring charge was \$529,000 related to contract cancellation costs that represented the estimated cost to buy out of the remaining term on printer, copier, and computer processing contracts that provided no future benefit to the Company as a result of the restructuring. All such assets have been taken out of service.

Asset impairments, which were a direct result of the consolidation of subsidiary functions, amounted to \$407,000. They consisted of capitalized programming and data center costs, voice systems, and leasehold and office improvements. These assets were written-down to zero. All such assets have been taken out of service.

Activity in the restructuring accrual is as follows:

	Employee Termination Benefits	Occupancy	Contract Cancellations	Total
	-----			
Restructuring				

charge	\$ 782,000	\$ 488,000	\$ 529,000	\$1,799,000
Cash payments	(343,000)	(47,000)	(365,000)	(755,000)
Reversal of prior accrual	(71,000)	--	(91,000)	(162,000)
-----				
Balance at December 31, 1999	\$ 368,000	\$ 441,000	\$ 73,000	\$ 882,000
-----				
Cash payments	(339,000)	(155,000)	(73,000)	(567,000)
Accrual adjustment	--	12,000	--	12,000
-----				
Balance at December 31, 2000	\$ 29,000	\$ 298,000	\$ --	\$ 327,000
Cash payments	(10,000)	(91,000)	--	(101,000)
-----				
Balance at December 31, 2001	\$ 19,000	\$ 207,000	\$ --	\$ 226,000
=====				

Based on revised estimates, \$162,000 of the restructuring accrual was reversed by a reduction to the restructuring charge in other underwriting expenses in the fourth quarter of 1999. Employee termination benefits and contract cancellation costs were lower than original estimates.

#### 19--GUARANTY FUND AND OTHER INSURANCE-RELATED ASSESSMENTS

The Company accrues 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. The Company's liabilities for guaranty-fund and other insurance-related assessments were \$3,605,090 and \$880,154 at December 31, 2001 and 2000, respectively. These liabilities included \$676,149 and \$397,832 related to surcharges collected by the Company on behalf of regulatory authorities for 2001 and 2000, respectively.

## 20--INTERIM FINANCIAL DATA (UNAUDITED)

	2001			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$40,040,902	\$41,651,990	\$ 42,598,703	\$43,478,259
Total revenues	44,792,026	46,496,969	46,365,986	47,508,642
Net losses and loss expenses	26,158,684	27,931,189	30,026,448	34,061,228
Net income (loss)	2,954,595	2,697,269	1,023,422	(857,155)
Net income (loss) per common share				
Basic	.33	.30	.11	(.10)
Diluted	.33	.30	.11	(.10)

	2000			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$36,088,698	\$36,447,134	\$39,149,006	\$39,961,361
Total revenues	40,357,333	41,333,363	44,229,060	44,661,831
Net losses and loss expenses	25,948,912	24,823,941	26,795,640	26,814,683
Net income	1,162,682	2,502,499	2,566,975	2,604,624
Net income per common share				
Basic	\$.14	\$.29	\$.29	\$.29
Diluted	.14	.29	.29	.29

## INDEPENDENT AUDITORS' REPORT

The Stockholders and Board of Directors  
Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2001 and 2000, 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, 2001. 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 auditing standards generally accepted in the United States of America. 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, 2001 and 2000, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Philadelphia, Pennsylvania  
February 21, 2002

## CORPORATE INFORMATION

### ANNUAL MEETING

April 18, 2002 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 Ralph G. Spontak, 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 National Market under the symbols "DGICA" and "DGICB." The Class A common stock and Class B common stock have traded on the Nasdaq National Market since April 20, 2001. All information given prior to that date relates to the Company's Common Stock, which previously traded on the Nasdaq National Market under the symbol "DGIC." The following table shows the dividends paid per share and the stock price range for each quarter during 2001 and 2000:

QUARTER	HIGH	LOW	CASH DIVIDEND DECLARED PER SHARE
2000			
1st	8.625	5.750	--
2nd	8.250	5.750	.09
3rd	8.000	5.750	.09
4th	13.938	7.125	.18
2001 - CLASS A			
1st	12.750	8.688	--
2nd	14.500	10.000	.10
3rd	14.590	12.170	.10
4th	13.880	9.100	.20
2001 - CLASS B			
1st	12.750	8.688	--
2nd	12.500	8.750	.09
3rd	13.100	11.010	.09
4th	11.750	9.000	.18

### CORPORATE OFFICES

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P.O. Box 302  
Marietta, Pennsylvania 17547-0302  
(717) 426-1931  
E-mail Address: [info@donegalgroup.com](mailto:info@donegalgroup.com)  
Donegal Web Site: [www.donegalgroup.com](http://www.donegalgroup.com)

### TRANSFER AGENT

EquiServe Trust Company, N.A.  
P.O. Box 2500  
Jersey City, New Jersey 07303-2500  
(800) 317-4445  
Web Site: [www.equiserve.com](http://www.equiserve.com)  
Hearing Impaired: TDD: 201-222-4955

### DIVIDEND REINVESTMENT PLAN

The Company offers a dividend reinvestment plan through its transfer agent.

For information contact:

Donegal Group Inc. Dividend Reinvestment Plan  
EquiServe Trust Company, N.A.

P.O. Box 2500  
Jersey City, New Jersey 07303-2500

### STOCKHOLDERS

The following represent the number of common stockholders of record as of December 31, 2001:

Class A common stock	586
Class B common stock	532





## SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of the following insurance companies:

Name - - - - -	State of Formation -----
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia
Pioneer Insurance Company	Ohio
Southern Heritage Insurance Company	Georgia

## Independent Auditors' Consent and Report on Schedules

The Board of Directors  
Donegal Group Inc.:

The audits referred to in our report dated February 21, 2002 include the related financial statement schedules as of December 31, 2001, and for each of the years in the three-year period ended December 31, 2001, included in the annual report on Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We consent to incorporation by reference in the registration statements (Nos. 333-06681, 333-25541, 333-26693, 333-61095, 333-93785, 333-94301, 333-62970, 333-62972, 333-62974 and 333-62976) on Forms S-8 and registration statement (No. 333-59828) on Form S-3 of Donegal Group Inc. of our reports dated February 21, 2002, relating to the consolidated balance sheets of Donegal Group Inc. as of December 31, 2001 and 2000, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows and related financial statement schedules for each of the years in the three-year period ended December 31, 2001, which reports are incorporated by reference or appear in the December 31, 2001 annual report on Form 10-K of Donegal Group Inc.

KPMG LLP

Philadelphia, Pennsylvania  
March 25, 2002