FORM 10-Q

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

o **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, P.O. Box 302, Marietta, PA	17547-0302
(Address of principal executive offices)	(Zip code)

(717) 426-1931

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether 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 o.

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

Large accelerated filer o   Accelerated filer ☑   Non-accelerated filer o.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date**:** 19,604,985 shares of Class A Common Stock, par value $0.01 per share, and 5,576,775 shares of Class B Common Stock, par value $0.01 per share, outstanding on October 31, 2006.

TABLE OF CONTENTS

Part I. Financial Information

Item 1. Financial Statements.

Donegal Group Inc. and Subsidiaries
Consolidated Balance Sheets

	September 30, 2006 (Unaudited)	December 31, 2005
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost	$ 172,771,224	$ 180,182,305
Available for sale, at fair value	331,249,541	295,097,235
Equity securities, available for sale, at fair value	44,310,926	33,371,360
Investments in affiliates	8,319,510	8,441,546
Short-term investments, at cost, which approximates fair value	23,680,018	30,653,668
Total investments	580,331,219	547,746,114
Cash	4,829,907	3,811,011
Accrued investment income	5,409,034	5,521,335
Premiums receivable	50,840,516	47,124,106
Reinsurance receivable	101,108,440	94,137,096
Deferred policy acquisition costs	25,222,064	23,476,593
Deferred tax asset, net	10,628,343	11,532,834
Prepaid reinsurance premiums	44,904,881	40,063,138
Property and equipment, net	5,039,643	5,234,423
Accounts receivable — securities	2,020,401	411,149
Federal income taxes recoverable	860,887	901,341
Due from affiliate	356,452	—
Other	1,799,161	1,462,448
Total assets	$ 833,350,948	$ 781,421,588
Liabilities and Stockholders’ Equity		
Liabilities		
Losses and loss expenses	$ 269,609,266	$ 265,729,527
Unearned premiums	202,883,033	186,660,050
Accrued expenses	11,049,542	12,706,485
Reinsurance balances payable	2,005,608	1,814,292
Cash dividends declared to stockholders	—	1,781,393
Subordinated debentures	30,929,000	30,929,000
Accounts payable — securities	3,343,634	896,893
Due to affiliate	—	728,486
Drafts payable	356,591	703,912
Other	1,571,046	1,575,364
Total liabilities	521,747,720	503,525,402

Stockholders' Equity

Preferred stock, $1.00 par value, authorized 2,000,000 shares; none issued	—	—
Class A common stock, $.01 par value, authorized 30,000,000 shares, issued 19,723,860 and 19,156,169 shares and outstanding 19,578,930 and 19,011,268 shares	197,239	191,562
Class B common stock, $.01 par value, authorized 10,000,000 shares, issued 5,649,240 shares and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	148,991,728	141,932,954
Accumulated other comprehensive income	4,063,000	2,532,073
Retained earnings	159,186,517	134,074,853
Treasury stock	(891,748)	(891,748)
Total stockholders' equity	311,603,228	277,896,186
Total liabilities and stockholders' equity	$ 833,350,948	$ 781,421,588

All 2005 capital accounts and share information have been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)

	Three Months Ended September 30, 2006	2005
Revenues:		
Net premiums earned	$ 75,705,387	$ 74,584,045
Investment income, net of investment expenses	5,385,705	4,548,837
Net realized investment gains	152,694	124,896
Lease income	243,998	242,495
Installment payment fees	1,131,873	1,066,182
Total revenues	82,619,657	80,566,455
Expenses:		
Net losses and loss expenses	42,555,787	41,071,801
Amortization of deferred policy acquisition costs	12,152,000	12,069,000
Other underwriting expenses	12,549,734	12,269,717
Policy dividends	520,147	572,344
Interest	725,994	588,360
Other expenses	489,804	289,686
Total expenses	68,993,466	66,860,908
Income before income tax expense	13,626,191	13,705,547
Income tax expense	3,807,890	3,928,390
Net income	$ 9,818,301	$ 9,777,157
Net income per common share:		
Basic	$ 0.39	$ 0.41
Diluted	$ 0.38	$ 0.39

Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended September 30, 2006	2005
Net income	$ 9,818,301	$ 9,777,157
Other comprehensive income (loss), net of tax		
Unrealized income (loss) on securities:		
Unrealized holding income (loss) during the period, net of income tax	5,416,304	(1,645,915)
Reclassification adjustment, net of income tax	(99,251)	(81,182)
Other comprehensive income (loss)	5,317,053	(1,727,097)
Comprehensive income	$ 15,135,354	$ 8,050,060

All 2005 per share information has been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc. and Subsidiaries
Consolidated Statements of Income
(Unaudited)

	Nine Months Ended September 30, 2006	2005
Revenues:		
Net premiums earned	$225,280,341	$219,784,658
Investment income, net of investment expenses	15,424,517	13,312,933
Net realized investment gains	1,034,741	1,235,248
Lease income	728,160	708,008
Installment payment fees	3,295,280	3,096,746
Total revenues	245,763,039	238,137,593
Expenses:		
Net losses and loss expenses	126,628,127	122,417,355
Amortization of deferred policy acquisition costs	36,020,000	35,291,000
Other underwriting expenses	37,566,486	37,914,521
Policy dividends	1,042,117	1,180,416
Interest	2,061,888	1,629,861
Other expenses	1,553,911	1,179,366
Total expenses	204,872,529	199,612,519
Income before income tax expense	40,890,510	38,525,074
Income tax expense	11,721,439	11,427,554
Net income	$ 29,169,071	$ 27,097,520
Net income per common share:		
Basic	$ 1.17	$ 1.13
Diluted	$ 1.14	$ 1.10

Consolidated Statements of Comprehensive Income
(Unaudited)

	Nine Months Ended September 30, 2006	2005
Net income	$29,169,071	$27,097,520
Other comprehensive income (loss), net of tax		
Unrealized gain (loss) on securities:		
Unrealized holding gain (loss) during the period, net of income tax	2,203,509	(1,500,359)
Reclassification adjustment, net of income tax	(672,582)	(802,911)
Other comprehensive income (loss)	1,530,927	(2,303,270)
Comprehensive income	$30,699,998	$24,794,250

All 2005 per share information has been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc. and Subsidiaries
Consolidated Statement of Stockholders' Equity
(Unaudited)
Nine Months Ended September 30, 2006

	Class A Shares	Class B Shares	Class A Amount	Class B Amount	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2005	19,156,169	5,649,240	$ 191,562	$ 56,492	$141,932,954	$ 2,532,073	$134,074,853	$(891,748)	$277,896,186
Issuance of common stock	50,156		502		984,226				984,728
Net income							29,169,071		29,169,071
Cash dividends							(3,993,481)		(3,993,481)
Exercise of stock options	517,535		5,175		4,088,581				4,093,756
Grant of stock options					63,926		(63,926)		—
Tax benefit on exercise of stock options					1,922,041				1,922,041
Other comprehensive income						1,530,927			1,530,927
Balance, September 30, 2006	19,723,860	5,649,240	$ 197,239	$ 56,492	$148,991,728	$ 4,063,000	$159,186,517	$(891,748)	$311,603,228

All 2005 capital accounts and share information have been restated for 4-for-3 stock split as discussed in footnote 1.

See accompanying notes to consolidated financial statements.

Donegal Group Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

	Nine Months Ended September 30, 2006	2005
Cash Flows from Operating Activities:		
Net income	$ 29,169,071	$ 27,097,520
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,023,178	2,259,065
Realized investment gains	(1,034,741)	(1,235,248)
Changes in assets and liabilities:		
Losses and loss expenses	3,879,739	(3,912,918)
Unearned premiums	16,222,983	18,919,351
Premiums receivable	(3,716,410)	(4,494,078)
Deferred acquisition costs	(1,745,471)	(2,000,262)
Deferred income taxes	80,140	(573,091)
Reinsurance receivable	(6,971,344)	3,811,825
Prepaid reinsurance premiums	(4,841,743)	(6,331,935)
Accrued investment income	112,301	(90,807)
Due from affiliate	(1,084,938)	(2,169,071)
Reinsurance balances payable	191,316	304,444
Current income taxes	40,454	3,010,646
Accrued expenses	(1,656,943)	482,664
Drafts payable	(347,321)	(633,070)
Other, net	(341,031)	(404,258)
Net adjustments	810,169	6,943,257
Net cash provided by operating activities	29,979,240	34,040,777
Cash Flows from Investing Activities:		
Purchase of fixed maturities:		
Held to maturity	—	(9,747,396)
Available for sale	(76,896,066)	(121,513,555)
Purchase of equity securities, available for sale	(24,918,543)	(14,628,556)
Maturity of fixed maturities:		
Held to maturity	6,869,266	8,748,151
Available for sale	25,290,261	14,458,997
Sale of fixed maturities:		
Held to maturity	—	860,000
Available for sale	18,143,309	42,313,754
Sale of equity securities, available for sale	14,791,496	14,084,732
Net decrease in investment in affiliates	18,378	69,399
Net purchases of property and equipment	(457,746)	(642,768)
Net sales of short-term investments	6,973,650	31,738,867
Net cash used in investing activities	(30,185,995)	(34,258,375)
Cash Flows from Financing Activities:		
Cash dividends paid	(5,774,874)	(5,052,317)
Issuance of common stock	5,078,484	942,147
Tax benefit on exercise of stock options	1,922,041	—
Net cash provided by (used in) financing activities	1,225,651	(4,110,170)
Net increase (decrease) in cash	1,018,896	(4,327,768)
Cash at beginning of period	3,811,011	7,350,330
Cash at end of period	$ 4,829,907	$ 3,022,562
Cash paid during period — Interest	$ 2,021,331	$ 1,571,275
Net cash paid during period — Taxes	$ 9,675,000	$ 8,950,000

See accompanying notes to consolidated financial statements.

DONEGAL GROUP INC. AND SUBSIDIARIES
(Unaudited)
Notes to Consolidated Financial Statements

1 – Organization

We were organized as an insurance holding company by Donegal Mutual Insurance Company (“Donegal Mutual”) on August 26, 1986. Through our insurance subsidiaries, we operate predominantly as an underwriter of personal and commercial lines of property and casualty insurance. Our personal lines products consist primarily of homeowners and private passenger automobile policies. Our commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers’ compensation policies. Our insurance subsidiaries, Atlantic States Insurance Company (“Atlantic States”), Southern Insurance Company of Virginia (“Southern”), Le Mars Insurance Company (“Le Mars”) and the Peninsula Insurance Group (“Peninsula”), which consists of Peninsula Indemnity Company and The Peninsula Insurance Company, write personal and commercial lines of property and casualty insurance exclusively through a network of independent insurance agents in certain Mid-Atlantic, Midwest and Southern states. Donegal Mutual and our insurance subsidiaries conduct business together as the Donegal Insurance Group. We also own approximately 48% of the outstanding stock of Donegal Financial Services Corporation (“DFSC”), a thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining approximately 52% of the outstanding stock of DFSC.

At September 30, 2006, Donegal Mutual held approximately 41% of our outstanding Class A common stock and approximately 69% of our outstanding Class B common stock.

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies proportionately share their combined underwriting results, excluding certain reinsurance assumed by Donegal Mutual from our insurance subsidiaries. See Note 4 – Reinsurance for more information regarding the pooling agreement.

On April 6, 2006, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33-1/3% stock dividend with a record date of April 17, 2006 and a distribution date of April 26, 2006. The capital stock accounts, all share amounts and earnings per share amounts for 2005 have been restated to reflect this stock split.

Effective as of September 21, 2005, certain members of the Donegal Insurance Group entered into an Acquisition Rights Agreement with The Shelby Insurance Company and Shelby Casualty Insurance Company (together, “Shelby”), part of Vesta Insurance Group, Inc. The agreement granted those members the right, effective January 1, 2006, at their discretion and subject to their traditional underwriting and agency appointment standards, to offer renewal or replacement policies to the holders of Shelby’s personal lines policies in Pennsylvania, Tennessee and Alabama, in connection with Shelby’s withdrawal from those three states. As part of the agreement, the Donegal Insurance Group is paying specified amounts to Shelby based on the direct premiums written by the Donegal Insurance Group on the renewal and replacement policies it issued. Net premiums written related to this agreement amounted to $1.9 million in the third quarter of 2006 and $4.8 million in the first nine months of 2006. The issuance of all remaining policies under the acquisition rights agreement was accelerated and completed in the third quarter.

2 – Basis of Presentation

Our financial information for the interim periods included herein is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of management, are necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods included herein. Our results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of our results of operations to be expected for the twelve months ending December 31, 2006.

These interim financial statements should be read in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2005.

3 – Earnings Per Share

The computation of basic and diluted earnings per share is as follows:

	Basic	Effect of Stock Options	Diluted
Three Months Ended September 30:			
2006			
Net income	$ 9,818,301	$ —	$ 9,818,301
Weighted average shares outstanding	25,125,648	525,112	25,650,760
Earnings per common share:			
Net income	$ 0.39	$ (0.01)	$ 0.38
2005			
Net income	$ 9,777,157	$ —	$ 9,777,157
Weighted average shares outstanding	23,990,898	905,543	24,896,441
Earnings per common share:			
Net income	$ 0.41	$ (0.02)	$ 0.39
Nine Months Ended September 30:			
2006			
Net income	$29,169,071	$ —	$29,169,071
Weighted average shares outstanding	24,891,516	621,792	25,513,308
Earnings per common share:			
Net income	$ 1.17	$ (0.03)	$ 1.14
2005			
Net income	$27,097,520	$ —	$27,097,520
Weighted average shares outstanding	23,962,408	785,588	24,747,996
Earnings per common share:			
Net income	$ 1.13	$ (0.03)	$ 1.10

All outstanding options are exercisable exclusively for the purchase of shares of Class A common stock and were included in the computation of diluted earnings per share.

4 – Reinsurance

Atlantic States has participated in an inter-company pooling agreement with Donegal Mutual since 1986. Both Atlantic States and Donegal Mutual place all of their direct business into the pool, and Atlantic States and Donegal Mutual then proportionately share the pooled business in accordance with the terms of the pooling agreement. Atlantic States has a 70% share of the results of the pool, and Donegal Mutual has a 30% share of the results of the pool. There have been no changes to the pool participation percentages since July 1, 2000.

The insurance operations of our subsidiaries are interrelated with the insurance operations of Donegal Mutual, and, while maintaining the separate corporate existence of each company, Donegal Mutual and our insurance subsidiaries conduct their insurance business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, management, employees and facilities and offer the same types of insurance products. We do not anticipate any changes in the pooling agreement with Donegal Mutual, including changes in Atlantic States' pool participation level in the foreseeable future.

The risk profiles of the business written by Atlantic States and Donegal Mutual historically have been, and continue to be, substantially similar. The products, classes of business underwritten, pricing practices and underwriting standards of both companies are determined and administered by the same management and underwriting personnel. Further, the companies share a combined business plan to achieve market penetration and underwriting profitability objectives. The products marketed by Atlantic States and Donegal Mutual are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of the respective companies generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but not all of the standard risk gradients are allocated to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by both companies are homogenized within the pool and each company shares the results according to its participation level, Atlantic States realizes 70% of the underwriting profitability of the pool (because of its 70% participation in the pool), while Donegal Mutual realizes 30% of the underwriting profitability of the pool (because of Donegal Mutual's 30% participation in the pool). Pooled business represents the predominant percentage of the net underwriting activity of both Atlantic States and Donegal Mutual.

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars and Peninsula have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and exposures. Several different reinsurers are used, all of which, consistent with Donegal Insurance Group's requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of management, is equivalent to a company with at least an A- rating. The following information relates to the external reinsurance Atlantic States, Southern and Donegal Mutual has in place during 2006:

- excess of loss reinsurance, under which losses are automatically reinsured, through a series of contracts, over a set retention ($400,000 for 2006), and
- catastrophic reinsurance, under which Donegal Insurance Group recovers, through a series of contracts, between 95% and 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention ($3.0 million for 2006).

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

In addition to the pooling agreement and third-party reinsurance, Atlantic States, Southern and Le Mars have various agreements with Donegal Mutual.

There were no significant changes to the pooling agreement, third-party reinsurance or other reinsurance agreements with Donegal Mutual during the three and nine months ended September 30, 2006 and 2005.

5 – Segment Information

We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries as determined under statutory accounting principles prescribed or permitted by various state insurance departments (“SAP”), which is used by management to measure performance for the total business of our insurance subsidiaries. Financial data by segment is as follows:

	Three Months Ended September 30,	
	2006	2005
	($ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	$ 28,684	$ 28,789
Personal lines	47,021	45,795
Net premiums earned	75,705	74,584
Net investment income	5,386	4,549
Realized investment gains	153	125
Other	1,376	1,308
Total revenues	$ 82,620	$ 80,566
Income before income taxes:		
Underwriting income:		
Commercial lines	$ 6,741	$ 5,894
Personal lines	215	2,291
SAP underwriting income	6,956	8,185
GAAP adjustments	971	416
GAAP underwriting income	7,927	8,601
Net investment income	5,386	4,549
Realized investment gains	153	125
Other	160	431
Income before income taxes	$ 13,626	$ 13,706

	Nine Months Ended September 30,	
	2006	2005
	($ in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	$ 86,550	$ 84,562
Personal lines	138,730	135,223
Net premiums earned	225,280	219,785
Net investment income	15,425	13,313
Realized investment gains	1,035	1,235
Other	4,023	3,805
Total revenues	$ 245,763	$ 238,138
Income before income taxes:		
Underwriting income:		
Commercial lines	$ 15,666	$ 13,089
Personal lines	5,719	8,538
SAP underwriting income	21,385	21,627
GAAP adjustments	2,639	1,355
GAAP underwriting income	24,024	22,982
Net investment income	15,425	13,313
Realized investment gains	1,035	1,235
Other	407	995
Income before income taxes	$ 40,891	$ 38,525

6 – Subordinated Debentures

On May 15, 2003, we received $15.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 15, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At September 30, 2006, the interest rate on the debentures was 9.51%.

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At September 30, 2006, the interest rate on the debentures was 9.34%.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after five years. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At September 30, 2006, the interest rate on the debentures was 9.25%.

7 – Share–Based Compensation

Effective January 1, 2006, we adopted Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," a revision of SFAS No. 123 and superseding APB Opinion No. 25. SFAS No. 123(R) requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income.

SFAS No. 123(R) does not set accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to nonemployees under the provisions of FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions involving Stock Compensation," and Emerging Issues Task Force Issue No. 00-23 (EITF 00-23), "Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25, Accounting for Stock Issued to Employees, and FIN No. 44, Accounting for Certain Transactions involving Stock Compensation." Pursuant to FIN No. 44, APB Opinion No. 25 did not apply to the separate financial statements of a subsidiary in accounting for share-based compensation granted by the subsidiary to employees of the parent or another subsidiary. EITF 00-23 states that when employees of a controlling entity are granted share-based compensation, the entity granting the share-based compensation should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to us, because Donegal Mutual is the employer of record for the majority of employees that provide services to us. As a result, the impact of the implementation of SFAS No. 123(R) was immaterial to our results of operations for the nine months ended September 30, 2006.

SFAS No. 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous rules. Tax benefits realized upon the exercise of stock options of $1.9 million for the nine months ended September 30, 2006 were classified as financing activities in our Consolidated Statements of Cash Flows.

8 – Impact of New Accounting Standards

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" (FIN No. 48) FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the impact of adopting FIN No. 48 to have a significant effect on our results of operations or financial condition.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The following information should be read in conjunction with the historical financial information and the notes thereto included in this Quarterly Report on Form 10-Q and Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on March 13, 2006.

On April 6, 2006, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33-1/3% stock dividend with a record date of April 17, 2006 and a distribution date of April 26, 2006. The capital stock accounts, all share amounts and earnings per share amounts for 2005 have been restated to reflect this stock split.

Critical Accounting Policies and Estimates

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

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

Liability for Losses and Loss Expenses

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

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

The reserve estimates of our insurance subsidiaries can change over time because of unexpected changes in assumptions related to their external environment and, to a lesser extent, assumptions as to their internal operations. Assumptions related to their external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and stability in economic conditions and the rate of loss cost inflation. For example, our insurance subsidiaries have experienced a decrease in claims frequency on bodily injury liability claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, they attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at September 30, 2006. For every 1% change in our estimate for loss and loss expense reserves of our insurance subsidiaries, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.7 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability of our insurance subsidiaries will not exceed their estimates of loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, the timing, frequency and extent of adjustments to the estimated future liabilities of our insurance subsidiaries cannot be predicted, since the historical conditions and events that serve as a basis for our estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Further adjustments could be required in the future. However, on the basis of our insurance subsidiaries' internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for losses and loss expenses.

Because of Atlantic States' participation in the pool with Donegal Mutual, Atlantic States is exposed to adverse loss development on the business of Donegal Mutual included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States would proportionately share any adverse risk development of the pooled business. The business in the pool is homogenous (i.e., Atlantic States has a 70% share of the entire pool and Donegal Mutual has a 30% share of the entire pool). Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its participation level under the terms of the pooling agreement, the underwriting pool is intended to produce a more uniform and stable underwriting result from year to year for each company than either would experience individually and to spread the risk of loss among each company.

The liability for losses and loss expenses of our insurance subsidiaries by major line of business as of September 30, 2006 and December 31, 2005 consisted of the following:

(dollars in thousands)	September 30, 2006	December 31, 2005
Commercial lines:		
Automobile	$ 23,195	$ 23,532
Workers' compensation	40,379	40,962
Commercial multi-peril	27,079	29,448
Other	3,143	3,088
Total commercial lines	93,796	97,030
Personal lines:		
Automobile	64,449	63,254
Homeowners	10,658	10,900
Other	1,667	1,825
Total personal lines	76,774	75,979
Total commercial and personal lines	170,570	173,009
Plus reinsurance recoverable	99,039	92,721
Total liability for losses and loss expenses	$ 269,609	$ 265,730

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

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of September 30, 2006	Percentage Change in Equity as of September 30, 2006(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2005	Percentage Change in Equity as of December 31, 2005(1)
	(dollars in thousands)			
(10.0)%	$ 153,513	3.6%	$ 155,708	4.0%
(7.5)	157,777	2.7	160,033	3.0
(5.0)	162,042	1.8	164,359	2.0
(2.5)	166,306	0.9	168,684	1.0
Base	170,570	—	173,009	—
2.5	174,834	-0.9	177,334	-1.0
5.0	179,099	-1.8	181,659	-2.0
7.5	183,363	-2.7	185,985	-3.0
10.0	187,627	-3.6	190,310	-4.0

(1) Net of income tax effect.

Investments

Our investments in available-for-sale fixed maturity and equity securities are presented at estimated fair value, which generally represents quoted market prices.

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at September 30, 2006 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 5,954,650	$ 35,055	$ 84,017,942	$2,150,642
Obligations of states and political subdivisions	10,764,458	20,561	52,880,811	498,383
Corporate securities	1,510,225	6,140	12,451,033	295,449
Mortgage-backed securities	11,211,870	119,421	39,887,640	1,209,569
Equity securities	6,882,636	737,121	1,648,550	313,834
Totals	$36,323,839	$918,298	$190,885,976	$4,467,877

Of the total fixed maturity securities with an unrealized loss at September 30, 2006, securities with a fair value of $119.0 million and an unrealized loss of $1.9 million are classified as available for sale and are carried at fair value on the balance sheet while securities with a fair value of $99.7 million and an unrealized loss of $2.4 million are classified as held to maturity on the balance sheet and are carried at amortized cost.

Substantially all of the unrealized losses within our fixed maturity investment portfolio resulted from increases in market interest rates and the related impact on our fixed maturity investment valuations.

We make estimates concerning the valuation of our investments and the recognition of other than temporary declines in the value of our investments. When we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its estimated net realizable value, and the amount of the write-down is reflected as a realized loss in our results of operations. We individually monitor all investments for other than temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in an unrealized loss position for more than six months, we assume there has been an other than temporary decline in value. With respect to debt securities, we assume there has been an other than temporary decline in value if it is probable that contractual payments will not be received. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, the deteriorating financial condition of the issuer of a security and the occurrence of industry, company and geographic events that have negatively impacted the value of a security or rating agency downgrades. In our determination, no investments trading below cost had declined on an other than temporary basis during the third quarter of 2006 or 2005. We determined that certain investments trading below cost had declined on an other than temporary basis during the first nine months of 2006 and 2005. Losses of $47,538 and $618,882 were included in net realized investment gains for these investments in the first nine months of 2006 and 2005, respectively.

Policy Acquisition Costs

Policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are directly related to the production of business, are deferred and amortized over the period in which the premiums are earned. The method followed in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premium to be earned, related investment income, losses and loss expenses and certain other costs expected to be incurred as the premium is earned. Estimates in the calculation of policy acquisition costs have not shown material variability because of uncertainties in applying accounting principles or as a result of sensitivities to changes in key assumptions.

Results of Operations — Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005

Net Premiums Written. Net premiums written for the three months ended September 30, 2006 were $80.4 million, an increase of $2.8 million, or 3.6%, over the comparable period in 2005. Commercial lines net premiums written decreased $405,000, or 1.4%, in the third quarter of 2006 compared to the comparable period in 2005, reflecting increased competition for quality commercial accounts. Personal lines net premiums written increased $3.2 million, or 6.5%, in the third quarter of 2006 compared to the comparable period in 2005. We have benefited during the third quarter of 2006 from the addition of the personal lines new business related to increased agent utilization of our WritePro automated underwriting system and the Shelby acquisition rights agreement. Net premiums written related to the acquisition rights agreement amounted to $1.9 million in the third quarter of 2006. The issuance of all remaining policies under the acquisition rights agreement was accelerated and completed in the third quarter.

Net Premiums Earned. Net premiums earned increased to $75.7 million for the third quarter of 2006, an increase of $1.1 million, or 1.5%, over the third quarter of 2005. Premiums are earned, or recognized as revenue, over the terms of the policies issued by our insurance subsidiaries, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the three months ended September 30, 2006, our net investment income increased 20.0% to $5.4 million, compared to $4.5 million for the comparable period one year ago. An increase in average invested assets from $529.4 million in the third quarter of 2005 to $570.8 million in the third quarter of 2006 and an increase in the annualized average rate of return on investments from 3.4% for the third quarter of 2005 to 3.8% for the third quarter of 2006 accounted for the increase in net investment income. The increase in our annualized average return reflects a shift from short-term investments to higher-yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during the third quarter of 2006 compared to the comparable period a year earlier. These increases were offset in part by decreases in our annualized average rate of return on our increased holdings of tax-exempt fixed maturities in our investment portfolio during the third quarter of 2006 compared to the comparable period a year earlier. The increased holdings of tax-exempt fixed maturities in 2006 resulted from a shift from taxable to tax-exempt fixed maturities in order to obtain more favorable after-tax yields.

Net Realized Investment Gains. Net realized investment gains in the third quarter of 2006 were $152,694, compared to $124,896 for the comparable period in 2005. No impairment charges were recognized in either period. Net realized investment gains in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses. The loss ratio of our insurance subsidiaries, which is the ratio of incurred losses and loss expenses to premiums earned, in the third quarter of 2006 was 56.2%, compared to 55.1% in the third quarter of 2005. The increase in the loss ratio reflected an increase in weather-related claims of approximately $2.0 million in the third quarter of 2006 compared to the third quarter of 2005, primarily related to the increased severe weather activity in the Mid-Atlantic region, including the effects of tropical storm Ernesto. The commercial lines loss ratio decreased to 43.8% in the third quarter of 2006, compared to 46.4% in the third quarter of 2005, primarily due to an decrease in the workers' compensation loss ratio as a result of a slight decrease in claim severity in that line of business. The personal lines loss ratio increased from 60.5% in the third quarter of 2005 to 64.0% in the third quarter of 2006 due to an increase in the private passenger auto loss ratio primarily related to a slight increase in claim severity in that line of business. The homeowners loss ratio increased from 57.1% in the third quarter of 2005 to 59.1% in the third quarter of 2006 primarily related to increased weather-related losses.

Underwriting Expenses. The expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the third quarter of 2006 and 2005 was 32.6%.

Combined Ratio. The combined ratio was 89.5% and 88.5% for the three months ended September 30, 2006 and 2005, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The slight increase in the combined ratio was largely attributable to the increase in the loss ratio for the 2006 period compared to the 2005 period as discussed above.

Interest Expense. Interest expense for the third quarter of 2006 was $725,994, compared to $588,360 for the third quarter of 2005, and reflected an increase in average interest rates on our subordinated debentures in the third quarter of 2006 compared to the comparable period in 2005.

Income Taxes. Income tax expense was $3.8 million for the third quarter of 2006, representing an effective tax rate of 27.9%, compared to $3.9 million for the third quarter of 2005, representing an effective tax rate of 28.7%. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in the 2006 period compared to the 2005 period.

Net Income and Earnings Per Share. Our net income for the third quarter of 2006 was $9.8 million, or $.38 per share on a diluted basis, comparable to the net income of $9.8 million, or $.39 per share on a diluted basis, reported for the third quarter of 2005. Our fully diluted shares outstanding for the third quarter of 2006 increased to 25.6 million, compared to 24.9 million for the third quarter of 2005.

Results of Operations — Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005

Net Premiums Written. Net premiums written for the nine months ended September 30, 2006 were $236.7 million, an increase of $4.3 million, or 1.9%, over the comparable period in 2005. Commercial lines net premiums written decreased $2.7 million, or 3.0%, in the first nine months of 2006 compared to the comparable period in 2005. Personal lines net premiums written increased $7.0 million, or 4.9%, in the first nine months of 2006 compared to the comparable period in 2005. We have benefited during the first nine months of 2006 from the addition of the personal lines new business related to the Shelby acquisition rights agreement. Net premiums written related to this agreement amounted to $4.8 million for the first nine months of 2006. The issuance of all remaining policies under the acquisition rights agreement was accelerated and completed in the third quarter.

Net Premiums Earned. Net premiums earned increased to $225.3 million for the first nine months of 2006, an increase of $5.5 million, or 2.5%, over the comparable period in 2005. Premiums are earned, or recognized as revenue, over the terms of the policies issued by our insurance subsidiaries, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the nine months ended September 30, 2006, our net investment income increased 15.8% to $15.4 million, compared to $13.3 million for the comparable period one year ago. An increase in average invested assets from $515.1 million in the first nine months of 2005 to $564.0 million in the first nine months of 2006 and an increase in the annualized average rate of return on investments from 3.4% for the first nine months of 2005 to 3.6% for the first nine months of 2006 accounted for the increase in net investment income. We realized increases in our annualized average rate of return as a result of a shift from short-term investments to higher-yielding fixed maturities in our investment portfolio as well as higher short-term interest rates during the first nine months of 2006 compared to the comparable period a year earlier. These increases were offset in part by decreases in our annualized average rate of return on increased holdings of tax-exempt fixed maturities in our investment portfolio during the first nine months of 2006 compared to the comparable period a year earlier.

Net Realized Investment Gains. Net realized investment gains in the first nine months of 2006 were $1.0 million, compared to $1.2 million for the comparable period in 2005. Impairment charges of $47,538 were recognized in the first nine months of 2006, compared to impairment charges of $618,882 recognized in the first nine months of 2005. The impairment charges for both periods were the result of declines in the market value of equity securities that we deemed to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from normal turnover within our investment portfolio.

Losses and Loss Expenses. The loss ratio of our insurance subsidiaries in the first nine months of 2006 was 56.2%, compared to 55.7% in the first nine months of 2005. The commercial lines loss ratio improved slightly to 48.9% in the first nine months of 2006, compared to 50.0% in the first nine months of 2005, primarily due to improved experience in the worker's compensation line of business. The personal lines loss ratio increased from 59.3% in the first nine months of 2005 to 61.1% in the first nine months of 2006 due to increased claim severity in the personal automobile line of business and increased weather-related losses in the homeowners line of business.

Underwriting Expenses. The expense ratio for the first nine months of 2006 was 32.7%, compared to 33.3% in the first nine months of 2005. The decrease in the first nine months of 2006 expense ratio reflects decreases in estimated guaranty fund assessments and underwriting-based incentive compensation.

Combined Ratio. The combined ratio was 89.3% and 89.5% for the nine months ended September 30, 2006 and 2005, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio.

Interest Expense. Interest expense for the first nine months of 2006 was $2.1 million, compared to $1.6 million for the first nine months of 2005, and reflected an increase in average interest rates on our subordinated debentures in the first nine months of 2006 compared to the comparable period in 2005.

Income Taxes. Income tax expense was $11.7 million for the first nine months of 2006, representing an effective tax rate of 28.7%, compared to $11.4 million for the first nine months of 2005, representing an effective tax rate of 29.7%. The change in effective tax rates is primarily due to tax-exempt interest income representing a greater proportion of net income before taxes in the 2006 period compared to the 2005 period.

Net Income and Earnings Per Share. Our net income for the first nine months of 2006 was $29.2 million, or $1.14 per share on a diluted basis, an increase of 7.8% over our net income of $27.1 million, or $1.10 per share on a diluted basis, reported for the first nine months of 2005. Our fully diluted shares outstanding for the first nine months of 2006 increased to 25.5 million, compared to 24.8 million for the first nine months of 2005.

Liquidity and Capital Resources

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

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with Donegal Mutual historically has been cash flow positive because of the historical underwriting profitability of the pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain a high degree of liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a “laddering” approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Net cash flows provided by operating activities in the first nine months of 2006 and 2005 were $30.0 million and $34.0 million, respectively. The decrease in our net cash flows provided by operating activities was primarily due to the adoption of SFAS No. 123(R), which requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under previous rules..

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company (“M&T”) relating to a four-year $35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of September 30, 2006, we have the ability to borrow $35.0 million at interest rates equal to M&T’s current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the nine months ended September 30, 2006, we had no borrowings outstanding under the credit agreement, and we were in compliance with all requirements of the credit agreement.

The following table shows our expected payments for significant contractual obligations as of September 30, 2006.

($ in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses of our insurance subsidiaries	$170,570	$74,967	$76,534	$ 8,801	$10,268
Subordinated debentures	30,929	—	—	—	30,929
Total contractual obligations	$201,499	$74,967	$76,534	$ 8,801	$41,197

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

On April 6, 2006, our board of directors declared a four-for-three stock split of our Class A common stock and our Class B common stock in the form of a 33-1/3% stock dividend with a record date of April 17, 2006 and a distribution date of April 26, 2006.

On October 19, 2006, our board of directors declared regular quarterly cash dividends of 8.25 cents per share for our Class A common stock and 7.0 cents per share for our Class B common stock, payable November 15, 2006 to stockholders of record as of the close of business on November 1, 2006. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis, and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of the applicable domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2005, our insurance subsidiaries' capital levels were each substantially above RBC requirements. At January 1, 2006, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were $21.9 million from Atlantic States, $5.4 million from Southern, $2.1 million from Le Mars and $2.9 million from Peninsula, all of which remained available at September 30, 2006.

As of September 30, 2006, we had no material commitments for capital expenditures.

Equity Price Risk

Our portfolio of marketable equity securities, which is carried on our consolidated balance sheets at estimated fair value, has exposure to the risk of loss resulting from an adverse change in prices. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff.

Credit Risk

Our portfolio of fixed-maturity securities and, to a lesser extent, our portfolio of short-term investments is subject to credit risk. This risk is defined as the potential loss in market value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing an analysis of prospective investments and through regular reviews of our portfolio by our investment staff. We also limit the percentage and amount of our total investment portfolio that can be invested in the securities of any one issuer.

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

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

Impact of Inflation

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

Risk Factors

The business, results of operations and financial condition, and therefore the value of our common stock, are subject to a number of risks. For a description of certain risks, reference is made to our 2005 annual report on Form 10-K, filed with the Securities and Exchange Commission on March 13, 2006.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our market risk generally represents the risk of gain or loss that may result from the potential change in the fair value of our investment portfolio as a result of fluctuations in prices and interest rates and, to a lesser extent, our debt obligations. We attempt to manage our interest rate risk by maintaining an appropriate relationship between the average duration of the investment portfolio and the approximate duration of liabilities, i.e., policy claims of our insurance subsidiaries and debt obligations.

We have maintained approximately the same investment mix and duration of our investment portfolio to our liabilities from December 31, 2005 to September 30, 2006.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2005 through September 30, 2006.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we (including our consolidated subsidiaries) are required to disclose in our periodic filings with the Securities and Exchange Commission is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

Certain forward-looking statements contained herein involve risks and uncertainties. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies and our business activities during 2006 and beyond. In some cases, you can identify forward-looking statements by terms such as “may,” “will,” “should,” “could,” “would,” “expect,” “plan,” “intend,” “anticipate,” “believe,” “estimate,” “project,” “predict,” “potential” and similar expressions. These forward-looking statements reflect our current views about future events, are based on assumptions that reflect current conditions and are subject to known and unknown risks and uncertainties that may cause our actual results to differ materially from those anticipated by these forward-looking statements. Many of the factors that will determine future events or our future results of operations are beyond our ability to control or predict.

Part II. Other Information

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities.

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1 July 1-31, 2006	Class A – None Class B – 347	Class A – None Class B – $16.55	Class A – None Class B – 347	(1)
Month #2 August 1-31, 2006	Class A – 13,333 Class B – 28,445	Class A – $19.25 Class B – $19.05	Class A – 13,333 Class B – 28,445	(1)
Month #3 September 1-30, 2006	Class A – None Class B – 523	Class A – None Class B – $17.21	Class A – None Class B – 523	(1)
Total	Class A – 13,333 Class B – 29,315	Class A – $19.25 Class B – $18.99	Class A – 13,333 Class B – 29,315	(1)

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

Item 3. Defaults upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit No.	Description
Exhibit 10.1	Amended and Restated Services Allocation Agreement dated October 19, 2006 between Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company, Peninsula Indemnity Company and Donegal Mutual Insurance Company (filed herewith)
Exhibit 10.2	First Amendment to Credit Agreement dated July 20, 2006 between Donegal Group Inc. and Manufacturers and Traders Trust Company (incorporated by reference to Exhibit 10.2 to Form 8-K filed with the Securities and Exchange Commission on July 21, 2006)
Exhibit 10.3	Amended and Restated Tax Sharing Agreement dated as of October 19, 2006 between Donegal Group Inc., Atlantic States Insurance Company, Southern Insurance Company of Virginia, Le Mars Insurance Company, The Peninsula Insurance Company and Peninsula Indemnity Company (incorporated by reference to Exhibit 10.1 to Form 8-K filed with the Securities and Exchange Commission on October 23, 2006)
Exhibit 31.1	Certification of Chief Executive Officer
Exhibit 31.2	Certification of Chief Financial Officer
Exhibit 32.1	Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code
Exhibit 32.2	Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	DONEGAL GROUP INC.
November 3, 2006	**By:** /s/ Donald H. Nikolaus Donald H. Nikolaus, President and Chief Executive Officer
November 3, 2006	**By:** /s/ Jeffrey D. Miller Jeffrey D. Miller, Senior Vice President and Chief Financial Officer

Exhibit 10.1

AMENDED AND RESTATED SERVICES ALLOCATION AGREEMENT

THIS AMENDED AND RESTATED SERVICES ALLOCATION AGREEMENT (this “Agreement”) is entered into this 19th day of October 2006 among DONEGAL GROUP INC., a Delaware corporation (“DGI”), ATLANTIC STATES INSURANCE COMPANY, a Pennsylvania stock casualty insurance company (“Atlantic States”), SOUTHERN INSURANCE COMPANY OF VIRGINIA, a Virginia stock casualty insurance company (“Southern”), LE MARS INSURANCE COMPANY, an Iowa stock casualty insurance company (“Le Mars”), THE PENINSULA INSURANCE COMPANY, a Maryland stock casualty insurance company (“Peninsula”), PENINSULA INDEMNITY COMPANY, a Maryland stock casualty insurance company (“PIC”, and, together with Atlantic States, Southern, Le Mars and Peninsula, the “Insurance Subsidiaries”) and DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company (“Donegal Mutual”).

WITNESSETH:

WHEREAS, Donegal Mutual formed DGI in August 1986 as part of a strategy to utilize a downstream holding company as a means of providing alternative sources of capital for Donegal Mutual’s insurance business;

WHEREAS, DGI, Donegal Mutual and Atlantic States, a wholly owned subsidiary of DGI, were parties to a Services Allocation Agreement dated September 29, 1986 (the “Prior Agreement”);

WHEREAS, the purpose of the Prior Agreement was to provide for the allocation of shared costs of certain employees of Donegal Mutual who have provided certain functions and services to DGI and certain of its subsidiaries since October 1, 1986 in connection with an intercompany pooling agreement between Donegal Mutual and Atlantic States;

WHEREAS, since October 1, 1986, DGI has acquired, and may in the future acquire, insurance companies for which employees of Donegal Mutual provide full-time services and Donegal Mutual is reimbursed on a direct basis for such services;

WHEREAS, Donegal Mutual has provided such services to DGI and the Insurance Subsidiaries in an efficient and effective manner;

WHEREAS, Donegal Mutual and DGI wish to continue a mutually beneficial relationship among Donegal Mutual and DGI for the respective benefit of Donegal Mutual and DGI and the Insurance Subsidiaries;

WHEREAS, DGI, Atlantic States and Donegal Mutual amended the Prior Agreement (the “Prior Amendment”) to remove Atlantic States as a party, to reflect developments in the respective businesses of DGI and the Insurance Subsidiaries and Donegal Mutual since the date of execution of the Prior Agreement and the interrelated nature of their businesses as conducted under the name Donegal Insurance Group and to provide for the appropriate allocation and payment of expenses in accordance with the current practices of Donegal Mutual, DGI and the Insurance Subsidiaries; and

WHEREAS, DGI, Donegal Mutual and the Insurance Subsidiaries wish to amend the Prior Amendment to reflect requests for changes to the Prior Amendment by certain state insurance departments and to restate the Prior Amendment as so amended;

NOW, THEREFORE, in consideration of the promises and mutual covenants herein contained and intending to be legally bound hereby, Donegal Mutual, DGI and the Insurance Subsidiaries agree as follows:

1. Effective Date. The effective date of this Agreement shall be November 1, 2006 (the “Effective Date”). This Agreement shall continue in effect unless and until terminated pursuant to Section 5.

2. Services To Be Provided.

(a) Donegal Mutual agrees to provide employees who shall perform the services described in Section 2(d) for and on behalf of and in the name of Atlantic States, and Donegal Mutual and Atlantic States agree that all of the costs and expenses of Donegal Mutual in providing those services and employees to Atlantic States shall be allocated between Donegal Mutual and Atlantic States in proportion to their respective participation from time to time under the Proportional Reinsurance Agreement dated as of September 29, 1986 and most recently amended as of April 20, 2000 between Donegal Mutual and Atlantic States.

(b) Donegal Mutual agrees to provide employees who shall, directly or indirectly, perform the services described in Section 2(d) for and on behalf of DGI and the Insurance Subsidiaries other than Atlantic States, and DGI and the Insurance Subsidiaries other than Atlantic States, agree either to reimburse Donegal Mutual or to allocate among Donegal Mutual, on the one hand, and DGI and the Insurance Subsidiaries other than Atlantic States, on the other hand, the costs and expenses of Donegal Mutual in providing such services and employees to DGI and the Insurance Subsidiaries other than Atlantic States.

(c) Donegal Mutual, DGI and the Insurance Subsidiaries agree that the fundamental purposes of this Agreement are (i) to secure the provision of the services described in Section 2(d) to DGI and the Insurance Subsidiaries and (ii) to assure that

Donegal Mutual receives appropriate payments from DGI and the Insurance Subsidiaries so that Donegal Mutual has no net cost for providing the services and employees, or, in the case of Atlantic States, for providing Atlantic States' proportionate share of such services and employees as described in Section 2(a), pursuant to this Agreement. Exhibit A to this Agreement provides specific but non-exclusive guidelines as to how such allocations and reimbursements shall be calculated and settled, and Exhibit A may be amended from time to time by the mutual agreement of Donegal Mutual, DGI and the Insurance Subsidiaries.

(d) The services are as follows:

(i) Underwriting – the development, implementation and administration of policies relating to underwriting and the acceptance of risks, the maintenance of underwriting manuals and guidelines and services relating to the development of insurance products and rates, the provision of all actuarial services necessary or appropriate for the operation of the Insurance Subsidiaries, the analysis of loss trends and reserve developments and risk concentrations and the arranging for insurance, loss control and other reasonable risk management services in the underwriting process to protect the Insurance Subsidiaries and their respective properties and other assets against loss, damage and liabilities;

(ii) Claims – the admitting, adjusting, compromising, rejection and settlement of claims under insurance policies issued by the Insurance Subsidiaries and the collection of reinsurance and recoverables;

(iii) Reinsurance – the review, negotiation, monitoring and coordination of all reinsurance contracts and placements, including the determination of the amounts, terms, types and structure of reinsurance to be obtained and the selection of the reinsurers;

(iv) Investments – the investment of all available funds in the name of DGI and the Insurance Subsidiaries pursuant to their respective investment policies, and the management of the respective investments of DGI and the Insurance Subsidiaries;

(v) Information Services – the purchase and maintenance of computer hardware and software systems and the creation, implementation and maintenance of computer programs utilized within those systems. Such systems shall include, but not be limited to, accounting and bookkeeping systems, automated underwriting and policy issuance systems, claims processing systems, premium billing systems, electronic imaging systems, Internet web systems and storage and processing systems for maintaining information to enable the preparation and analysis of daily, weekly and monthly reports;

(vi) Personnel and Professional Services – the appointment, direction, removal and suspension, in the name of DGI and the Insurance Subsidiaries, of employees and agents, including the determination of the appropriate levels thereof, and the ongoing review and analysis of professional services, including the retention of counsel, accountants, actuaries and other consultants;

(vii) Financial Reporting – the analysis and reporting of actual performance to budgeted performance, including analysis of financial results through the budgeted period and the preparation of all statements and reports necessary or appropriate for the respective businesses of DGI and the Insurance Subsidiaries, including reports to insurance regulatory authorities and the Securities and Exchange Commission;

(viii) Tax Administration – the ordinary and necessary tax administration services for income taxes, premium taxes, sales and use taxes, franchise and similar taxes and any other taxes incurred;

(ix) Accounting Services – the providing of routine accounting and bookkeeping services relating to cash, cash equivalents, receivables, supplies and other inventory items, fixed assets and other asset accounting, accounts payable, notes payable, other trade payables, payroll and payroll taxes, other general ledger items, accounting services relating to investments and the reconciliation of all bank accounts;

(x) Policyholder Services – the maintenance of policyholders' customer relation services and the maintenance of policyholder information, including names, addresses, policy anniversary dates and premiums due;

(xi) Internal Audit and Compliance Services – the providing of internal audit and compliance services to obtain an ongoing independent and objective evaluation of the internal control systems designed to provide reasonable assurance regarding the efficiency and effectiveness of operations, the reliability of financial reporting and compliance with applicable laws and regulations;

(xii) Actuarial Services – the providing of actuarial services including review and analysis of claims reserving assumptions, historical claims experience and 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; and

(xiii) Marketing, Sales and Advertising Services – the creation and development of marketing, sales and advertising programs, media and agency co-op promotional materials to further increase brand awareness and promote the sales of insurance products and services.

(e) Donegal Mutual shall use its best efforts to provide the services described above and such other or additional services as DGI or the Insurance Subsidiaries may from time to time request pursuant to this Agreement. Notwithstanding the foregoing, DGI and the Insurance Subsidiaries agree that Donegal Mutual shall have no obligation to provide services to DGI and the Insurance Subsidiaries of a quality greater than the quality of such services that Donegal Mutual maintains for its own operations.

(f) Donegal Mutual shall, within 90 days after the expiration of each calendar year during the term of this Agreement, furnish the Boards of Directors of DGI and the Insurance Subsidiaries with a written report as to the allocations and reimbursements between Donegal Mutual, on the one hand, and DGI and the Insurance Subsidiaries, on the other hand, during such year as shall be sufficient, (i) in the discretion of the disinterested members of the Boards of Directors of DGI and the Insurance Subsidiaries, to provide a commercially reasonable basis to reach the conclusion that the transactions between Donegal Mutual, on the one hand, and DGI and the Insurance Subsidiaries, on the other hand, have been fair to DGI and its stockholders under prevailing circumstances and (ii) as shall be sufficient in the discretion of the disinterested members of Donegal Mutual's Board of Directors, to provide a commercially reasonable basis to reach the conclusion that the transactions between Donegal Mutual, on the one hand, and DGI and the Insurance Subsidiaries, on the other hand, have been fair to Donegal Mutual and its policyholders under prevailing circumstances.

(g) Nothing in this Agreement shall constitute or be construed to be or create a partnership or joint venture relationship between DGI and the Insurance Subsidiaries, on the one hand and Donegal Mutual, on the other hand, and Donegal Mutual's status under this Agreement shall be that of an independent contractor. In connection with the performance of services under this Agreement, neither DGI, the Insurance Subsidiaries nor Donegal Mutual shall make any statement or take any action that is inconsistent with the provisions of this Section 2(g). It is understood and agreed that the management, control and direction of the operations and policies of DGI and the Insurance Subsidiaries shall remain at all times under the exclusive control of the respective boards of directors of DGI and the Insurance Subsidiaries.

(h) In the event that an issue or question arises in the future as to how this Agreement should be interpreted or whether the provisions of this Agreement should or should not apply in a particular set of circumstances as to a particular transaction between Donegal Mutual and DGI or one of the Insurance Subsidiaries, the issue or question shall be referred, upon the request of any of Donegal Mutual, DGI or the Insurance Subsidiary, for resolution to the Coordinating Committee maintained by the Boards of Directors of Donegal Mutual and DGI, and the decision of the Coordinating Committee with respect to such issue or question shall be final and binding on Donegal Mutual, DGI and the Insurance Subsidiaries.

3. <u>Books and Records</u>.

(a) Donegal Mutual shall keep accurate records and accounts of all services provided pursuant to this Agreement. Such records and accounts shall be maintained in accordance with sound business practices and shall be subject to such systems of internal control as are required by law. All records and accounts shall be available for inspection by DGI, the Insurance Subsidiaries and their respective representatives, including DGI's independent registered public accounting firm, at any time upon request during commercially reasonable hours.

(b) All of Donegal Mutual's records and accounts shall be its property, subject to the right of inspection of DGI and the Insurance Subsidiaries under Section 3(a) of this Agreement and the examination rights of insurance and other applicable regulatory authorities. All records and accounts of each Insurance Subsidiary shall be its property.

(c) DGI and the Insurance Subsidiaries, as the case may be, shall be solely responsible, severally and not jointly, for, and shall hold harmless and indemnify Donegal Mutual, including its successors, officers, directors, employees, agents and affiliates, from and against all losses, claims, damages, liabilities and expenses, including any and all reasonable expenses and attorneys' fees and disbursements incurred in investigating, preparing or defending against any litigation or proceeding, whether commenced or threatened, or any other claim whatsoever, whether or not resulting in any liability, suffered, incurred, made, brought or asserted by any person not a party to this Agreement in connection with Donegal Mutual's provision of services to DGI and the Insurance Subsidiaries, unless such loss, claim, damage, liability or expense results from the negligence, willful misconduct or fraud of Donegal Mutual or its officers, directors, employees, agents or affiliates or any other person engaged by Donegal Mutual to provide services to DGI and the Insurance Subsidiaries.

(d) Donegal Mutual shall be solely responsible for, and shall hold harmless and indemnify DGI and the Insurance Subsidiaries, as the case may be, including their respective successors, officers, directors, employees, agents and affiliates, from and against all losses, claims, damages, liabilities and expenses, including any and all reasonable expenses and attorneys' fees and disbursements incurred in investigating, preparing or defending against any litigation or proceeding, whether commenced or threatened, or any other claim whatsoever, whether or not resulting in any liability, suffered, incurred, made, brought or asserted by any person not a party to this Agreement resulting from the negligence, willful misconduct or fraud of Donegal Mutual or its officers, directors, employees, agents or affiliates or any other person engaged by Donegal Mutual to provide services to DGI and the Insurance Subsidiaries.

4. Approval by the Pennsylvania Department of Insurance. Donegal Mutual has submitted this Agreement to the Pennsylvania Department of Insurance for its review and approval in accordance with Chapter 14 of the Insurance Company Law of Pennsylvania, and such approval has been obtained.

5. Termination. This Agreement shall have a term that initially expires on December 31, 2011, provided, however, that, on each December 31 after the Effective Date of this Agreement, the term of this agreement shall be extended by one year so that at all times this Agreement shall have a then current term of five years; provided, however, that this Agreement may be terminated at any time prior to its then termination date in any of the following events, subject, in all events, to the receipt of any necessary insurance regulatory filings or actions:

(a) By Donegal Mutual, upon 180 days prior written notice to DGI and the Insurance Subsidiaries, if a Change of Control (as defined in this Agreement) of DGI shall have occurred. As used herein, “Change of Control” shall mean (i) the acquisition of shares of DGI by any “person” or “group,” as such terms are used in Rule 13d-3 under the Securities Exchange Act of 1934 as now or hereafter amended, in a transaction or series of transactions that result in such person or group directly or indirectly becoming the beneficial owner of 25% or more of the voting power of DGI’s common stock after the date of this Agreement, (ii) the consummation of a merger or other business combination after which the holders of voting common stock of DGI do not collectively own 60% or more of such voting common stock of the entity surviving such merger or other business combination, (iii) the sale, lease, exchange or other transfer in a transaction or series of transactions of all or substantially all of the assets of DGI, but excluding therefrom the sale and reinvestment of the investment portfolio of DGI and the Insurance Subsidiaries or (iv) as the result of or in connection with any cash tender offer or exchange offer, merger or other business combination, sale of assets or contested election of directors or any combination of the foregoing transactions specified in clauses (i), (ii), (iii) and (iv), each, a “Transaction”, the persons who constituted a majority of the members of the Board of Directors of DGI on the date of this Agreement and persons whose election as members of the Board of Directors of DGI was approved by such members then still in office or whose election was previously so approved after the date of this Agreement but before the event that constitutes a Change of Control, no longer constitute such a majority of the members of the Board of Directors of DGI then in office. A Transaction shall be deemed to constitute a Change in Control only upon the consummation of the Transaction.

(b) By DGI and the Insurance Subsidiaries, upon 30 days prior written notice to Donegal Mutual, if Donegal Mutual shall have become insolvent or shall have become subject to any voluntary or involuntary conservatorship, receivership, reorganization, liquidation or bankruptcy case or proceeding.

(c) By Donegal Mutual, DGI and the Insurance Subsidiaries at any time by mutual written agreement.

(d) The aforesaid respective rights of termination of DGI, the Insurance Subsidiaries and Donegal Mutual may be exercised without prejudice to any other remedy to which DGI, the Insurance Subsidiaries or Donegal Mutual, as the case may be, is entitled in law or in equity.

6. Miscellaneous.

(a) All notices, communications and deliveries under this Agreement shall (i) be made in writing, signed by the party making the same to the address as specified below, (ii) specify the section of this Agreement pursuant to which such notice is given, (iii) be deemed to be given if delivered in person, on the date delivered, or if sent by facsimile, on the date sent (if the party giving the notice, or its employee or agent, has no reason to believe that the facsimiled notice was not made or received), or if sent by Federal Express or some other overnight express courier with costs paid, on the date delivered to such express courier and (iv) be deemed received if delivered in person, on the date of personal delivery, or if by facsimile, on the first business day after sent (if the party giving the notice, or its employee or agent, has no reason to believe that the facsimiled notice was not made or received), or if sent by Federal Express or some other overnight express courier, on the first business day after delivered to such overnight express courier:

if to DGI, to:

Donegal Group Inc.
1195 River Road
Marietta, Pennsylvania 17547
Attention: President
Facsimile: 717-426-7009

if to Donegal Mutual, to:

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

if to Atlantic States, to:

Atlantic States Insurance Company
1195 River Road
Marietta, Pennsylvania 17547
Attention: Chief Executive Officer
Facsimile: 717-426-7009

if to Southern, to:

Southern Insurance Company of Virginia
1195 River Road
Marietta, Pennsylvania 17547
Attention: Chief Executive Officer
Facsimile: 717-426-7009

if to Le Mars, to:

Le Mars Insurance Company
1195 River Road
Marietta, Pennsylvania 17547
Attention: Chief Executive Officer
Facsimile: 717-426-7009

if to Peninsula and/or PIC, to:

The Peninsula Insurance Company
1195 River Road
Marietta, Pennsylvania 17547
Attention: Chief Executive Officer
Facsimile: 717-426-7009

Such notice shall be given at such other address or to such other representative as a party to this Agreement may furnish pursuant to this Section 6(a) to the other party to this Agreement.

(b) No assignment, transfer or delegation, whether by merger or other operation of law or otherwise, of any rights or obligations under this Agreement shall be made by a party to this Agreement without the prior written consent of the other party to this Agreement and, if required by applicable law, the Pennsylvania Commissioner of Insurance and any other insurance regulatory authority having jurisdiction over this Agreement. This Agreement shall be binding upon the parties hereto and their respective permitted successors and assigns.

(c) This Agreement constitutes the entire agreement of the parties to this Agreement with respect to its subject matter, supersedes all prior agreements, including the Prior Agreement, of the parties to this Agreement with respect to its subject matter and may not be amended except in writing signed by the party to this Agreement against whom the change is asserted. The failure of any party to this Agreement at any time or times to require the performance of any provision of this Agreement shall in no manner affect the right to enforce the same and no waiver by any party to this Agreement of any provision or breach of any provision of this Agreement in any one or more instances shall be deemed or construed either as a further or continuing waiver of any such provision or breach or as a waiver of any other provision or breach of any other provision of this Agreement.

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

(e) This Agreement shall be governed by and construed in accordance with the laws of the Commonwealth of Pennsylvania.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement the day and year first above written.

DONEGAL MUTUAL INSURANCE COMPANY

By: /s/ Jeffrey D. Miller
Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer

DONEGAL GROUP INC.

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, President
and Chief Executive Officer

ATLANTIC STATES INSURANCE COMPANY

By: /s/ Daniel J. Wagner
Daniel J. Wagner, Senior Vice President
and Treasurer

SOUTHERN INSURANCE COMPANY OF VIRGINIA

By: /s/ Jeffrey D. Miller
Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer

LE MARS INSURANCE COMPANY

By: /s/ Donald H. Nikolaus
Donald H. Nikolaus, President
and Chief Executive Officer

THE PENINSULA INSURANCE COMPANY

By: /s/ G. Eric Crouchley, III
G. Eric Crouchley, III, President

PENINSULA INDEMNITY COMPANY

By: /s/ G. Eric Crouchley, III
G. Eric Crouchley, III, President

EXHIBIT A

Services Allocation Agreement
Allocation and Reimbursement Guidelines

The following information sets forth allocation and reimbursement guidelines to be followed for the calculation and settlement of amounts pursuant to the Agreement.

1. Personnel Costs.

Personnel Costs as used in this Exhibit A shall be defined to include salaries and payroll tax expense. Calculation and settlement of allocations and reimbursements of personnel costs shall be performed as follows:

(a) For DGI and the Insurance Subsidiaries other than Atlantic States receiving services from Donegal Mutual employees, DGI and the Insurance Subsidiaries shall reimburse Donegal Mutual for the direct costs of the employees performing such services . Donegal Mutual may also recover an administration fee to cover its costs of services rendered to maintain records and process payroll for DGI and the Insurance Subsidiaries.

(b) Atlantic States shall reimburse Donegal Mutual for its proportionate share of Donegal Mutual's personnel costs, after subtracting direct reimbursements from DGI and the Insurance Subsidiaries other than Atlantic States as described in Section 1(a), in accordance with the following allocation methods:

(i) Underwriting and general personnel costs shall be allocated in proportion to Donegal Mutual's and Atlantic States' respective participation under the Proportional Reinsurance Agreement.

(ii) Claim personnel costs shall be allocated in proportion to Donegal Mutual's and Atlantic States' respective average claim reserves and loss payments

(iii) Investment personnel costs shall be allocated in proportion to Donegal Mutual's and Atlantic States' respective average invested assets. Such costs shall include the proportionate amount of personnel costs for individuals who perform duties related to Donegal Mutual's and Atlantic States' investment portfolios.

(iv) Information technology and operational services personnel costs shall be allocated proportionately to the allocations calculated in (i) through (iii) above to reflect the provision of information technology and operational services to each of the respective functions.

(c) Donegal Mutual shall provide to DGI and the Insurance Subsidiaries periodic calculations of amounts pursuant to Section 1(a) and (b), and DGI and the Insurance Subsidiaries shall reimburse Donegal Mutual in the normal course of business, generally within 30 days of receipt of such calculations.

2. Information Services.

To the extent that Donegal Mutual purchases and maintains the computer hardware and software systems required to service the business underwritten by Donegal Mutual and one or more of the Insurance Subsidiaries, calculation and settlement of allocations and reimbursements for such services shall be performed as follows:

(a) The estimated purchase price and development costs of computer hardware and software systems required to provide such services shall be divided by the number of years those systems are reasonably expected to serve the respective information services requirements of Donegal Mutual, DGI and one or more of the Insurance Subsidiaries. Such estimated annual cost shall then be allocated to the respective companies based upon their proportionate net written premiums in the year prior to the establishment of the allocation amounts.

(b) The Insurance Subsidiaries shall reimburse Donegal Mutual for the amounts so allocated on a monthly basis.

3. Miscellaneous Expenses.

(a) DGI and the Insurance Subsidiaries other than Atlantic States shall reimburse Donegal Mutual for miscellaneous direct and allocated expenses including, but not limited to, postage, in-house printing services and insurance purchased by Donegal Mutual on their behalf. DGI and the Insurance Subsidiaries shall reimburse Donegal Mutual such allocation amounts in the normal course of business, generally within 30 days of receipt of such allocations.

(b) Atlantic States shall reimburse Donegal Mutual on a monthly basis for its proportionate share of Donegal Mutual's expenses other than information systems depreciation expense, charitable contributions, real estate expenses and real estate taxes and any other expenses for services solely benefiting Donegal Mutual and after subtracting direct reimbursements from DGI and the Insurance Subsidiaries other than Atlantic States as described in Section 3(a) in accordance with the following allocation methods:

(i) Underwriting and general expenses allocated to the underwriting function shall be allocated in proportion to the respective participation of Donegal Mutual and Atlantic States under the Proportional Reinsurance Agreement.

(ii) Claim adjusting expenses and general expenses allocated to the claim function shall be allocated in proportion to the respective average claim reserves and loss payments of Donegal Mutual and Atlantic States.

(iii) General expenses allocated to the investment function shall be allocated in proportion to the respective average invested assets of Donegal Mutual and Atlantic States.

Exhibit 31.1

Certification

I, Donald H. Nikolaus, President and Chief Executive Officer of Donegal Group Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2006 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2006

/s/ Donald H. Nikolaus
Donald H. Nikolaus,
President and Chief Executive Officer

Exhibit 31.2

Certification

I, Jeffrey D. Miller, Senior Vice President and Chief Financial Officer of Donegal Group Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q for the quarter ended September 30, 2006 of Donegal Group Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report.

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 3, 2006

/s/ Jeffrey D. Miller
Jeffrey D. Miller, Senior Vice President
and Chief Financial Officer

Exhibit 32.1

Statement of Chief Executive Officer
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, the undersigned, Donald H. Nikolaus, the President and Chief Executive Officer of Donegal Group Inc., hereby certifies that, to the best of his knowledge:

1. Our Form 10-Q Quarterly Report for the period ended September 30, 2006 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, our financial condition and results of operations.

Dated: November 3, 2006

/s/ Donald H. Nikolaus
Donald H. Nikolaus, President
and Chief Executive Officer

Exhibit 32.2

Statement of Chief Financial Officer
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, the undersigned, Jeffrey D. Miller, the Senior Vice President and Chief Financial Officer of Donegal Group Inc., hereby certifies that, to the best of his knowledge:

1. Our Form 10-Q Quarterly Report for the period ended September 30, 2006 (the "Report") fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and

2. The information contained in the Report fairly presents, in all material respects, our financial condition and results of operations.

Dated: November 3, 2006	/s/ Jeffrey D. Miller
	Jeffrey D. Miller, Senior Vice President and Chief Financial Officer