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

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

For the fiscal year ended December 31, 1996
OR

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

For the transition period from _____ to _____
Commission file number 0-15341

DONEGAL GROUP INC.
(Exact name of registrant as specified in its charter)

| Delaware | 23-2424711 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 1195 River Road, Marietta, Pennsylvania | 17547 |
| (Address of principal executive offices) | (Zip code) |

Registrant's telephone number, including area code: (717) 426-1931
Securities registered pursuant to Section 12(b) of the Act: None.

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

Common Stock, $1.00 par value
(Title of class)

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

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

On March 14, 1997, the aggregate market value (based on the closing sales price on that date) of the voting stock held by non-affiliates of the Registrant was $42,732,252.

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date: 4,479,557 shares of Common Stock outstanding on March 14, 1997.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Registrant's annual report to stockholders for the fiscal year ended December 31, 1996 are incorporated by reference into Parts I, II and IV of this report.

2. Portions of the Registrant's proxy statement relating to the annual meeting of stockholders to be held April 17, 1997 are incorporated by reference into Part III of this report.

DONEGAL GROUP INC.

INDEX TO FORM 10-K REPORT

PART I

Item 1. Business.

(a) General Development of Business.

Donegal Group Inc. is a regional insurance holding company formed in August 1986 which is headquartered in Pennsylvania and engages, through its subsidiaries, in the property and casualty insurance business. As used herein, "DGI" or the "Company" refers to Donegal Group Inc. and its subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Delaware Atlantic Insurance Company, formerly known as Delaware American Insurance Company ("Delaware Atlantic"), and Atlantic Insurance Services, Inc. ("AIS"). DGI is currently 58.5% owned by Donegal Mutual Insurance Company (the "Mutual Company"). The Mutual Company's principal subsidiaries are Pioneer Insurance Company ("Pioneer") and Aberdeen Insurance Group, Inc. ("Aberdeen"). DGI and the Mutual Company and their subsidiaries underwrite a broad line of personal and commercial coverages, consisting of private passenger and commercial automobile, homeowners, commercial multi-peril, workers' compensation and other lines of insurance.

Atlantic States, which DGI organized in September 1986, participates in an underwriting pool whereby it cedes to the Mutual Company the premiums, losses and loss expenses from all of its insurance business and assumes from the Mutual Company a specified portion of the pooled business, which also includes substantially all of the Mutual Company's property and casualty insurance business. Effective as of October 1, 1986, DGI entered into a pooling agreement with the Mutual Company whereby Atlantic States assumed 35% of the pooled business written or in force on or after October 1, 1986. Effective October 1, 1988, the pooling agreement was amended to provide for the assumption by Atlantic States of 50% of the pooled business written or in force on or after October 1, 1988. Effective January 1, 1993, the pooling agreement was further amended to provide for the assumption by Atlantic States of 60% of the pooled business written or in force on or after January 1, 1993. Effective January 1, 1996, the pooling agreement was further amended to provide for the assumption by Atlantic States of 65% of the pooled business written or in force on or after January 1, 1996. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in Item 7 hereof and Note 2 to the Consolidated Financial Statements incorporated by reference herein.

On December 29, 1988, DGI acquired all of the outstanding capital stock of Southern in exchange for a $3,000,000 equity contribution to Southern. On October 1, 1986, the Mutual Company and Southern's predecessor, Southern Mutual Insurance Company, entered into a reinsurance agreement whereby such predecessor ceded to the Mutual Company 80% of its direct premiums written, less outside reinsurance, and retained 20%. Effective January 1, 1991, this percentage was changed to 50% ceded to the Mutual Company and 50% retained by Southern. Because the Mutual Company places substantially all of the business assumed from Southern in the pool, from which DGI currently has a 65% allocation, DGI's results of operations

include approximately 80% of the business written by Southern. See Note 2 to the Consolidated Financial Statements incorporated by reference herein.

As of March 31, 1993, the Mutual Company converted Pioneer Mutual Insurance Company into Pioneer, a stock insurance company, which writes property and casualty insurance in Ohio, and acquired all of Pioneer's capital stock. Pioneer does not currently participate in the pooling agreement. In connection with the Pioneer transaction, the Mutual Company was admitted in Ohio and began active marketing of its insurance products in Ohio in the fourth quarter of 1993.

In January 1994, DGI organized a new subsidiary, AIS, which began business in that same month. AIS is an insurance services organization currently providing inspection and policy auditing information on a fee for service basis to its affiliates and the insurance industry.

In December 1994, the Superintendent of Insurance of the State of Ohio issued an order permitting the sale by the Mutual Company to DGI of all of the outstanding capital stock of Pioneer at the independently determined fair market value thereof at the date of sale. It is anticipated that this sale will occur on or before March 31, 1997. Pioneer and the Mutual Company are parties to an excess of loss reinsurance agreement whereby the Mutual Company reinsures Pioneer for losses in excess of $100,000 up to a limit of $150,000, and a property catastrophe excess of loss reinsurance agreement whereby the Mutual Company reinsures Pioneer for catastrophe losses in excess of $200,000 up to a limit of $2,800,000.

As of December 31, 1995, the Company acquired all of the outstanding capital stock of Delaware Atlantic pursuant to a Stock Purchase Agreement dated as of December 21, 1995 between the Company and the Mutual Company. As part of this transaction, the Mutual Company entered into an aggregate excess of loss reinsurance agreement with Delaware Atlantic whereby the Mutual Company insured the risk of any loss from an adverse development in Delaware Atlantic's loss and loss adjustment expense reserve at the end of 1995 compared to the end of 1996 and losses and loss adjustment expenses incurred by Delaware Atlantic during the month of December 1995 and for the 1996 year by reason of the fact that Delaware Atlantic's loss and loss adjustment expense ratio for those periods exceeded the lesser of the loss and loss expense ratios of immediately preceding periods or 60%. This agreement resulted in no additional payment from the Mutual Company to Delaware Atlantic.

On May 3, 1996, the Mutual Company formed Aberdeen, which, pursuant to an Asset Purchase Agreement dated July 31, 1996, purchased all of the aggregate excess and surplus lines insurance agency business of Thomas G. Downie Agency, Inc. d/b/a Aberdeen Insurance Group ("Downie Agency") for a purchase price of $100,000. As part of the agreement, Aberdeen acquired, among other things, fixed assets, the right, title and interest in and to the name "Aberdeen Insurance Group," all of Downie Agency's books and records relating to its excess and surplus insurance lines agency business and all intangible

property rights and proprietary information of Downie Agency relating to the operation of the excess and surplus lines insurance agency business that was acquired.

Effective July 1, 1996, the Mutual Company entered into Retrocessional Reinsurance Agreements with each of Southern, Delaware Atlantic and Pioneer, (individually, an "Affiliate"), whereby the Mutual Company agreed to indemnify each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and retrocede 100% of the net liability back to each Affiliate, which the Affiliate assumes.

(b) Financial Information about Industry Segments.

The Company is of the opinion that all of its operations are within one industry segment and that no information as to industry segments is required pursuant to Statement of Financial Accounting Standards No. 14 or Regulation S-K.

(c) Narrative Description of Business.

Relationship with the Mutual Company

DGI's operations are interrelated with the operations of the Mutual Company and, because of the percentage of the pooled business assumed by DGI, DGI's results of operations are largely dependent upon the success of the Mutual Company. In addition, various reinsurance agreements exist between the Company and the Mutual Company. The Mutual Company is responsible for underwriting and marketing the pooled business and provides facilities, employees and services required to conduct the business of DGI on a cost allocated basis. The Mutual Company owned 58.5% of DGI as of March 14, 1997.

Through the pool, DGI writes personal and commercial property and casualty insurance lines, including automobile, homeowners, commercial multi-peril, workers' compensation and other lines of business. The insurance agencies under contract with the Mutual Company serve as representatives for the pool participants.

Under the terms of the intercompany pooling agreement, which took effect on October 1, 1986, Atlantic States cedes to the Mutual Company the premiums, losses and loss expenses on all of its insurance business. Substantially all of the Mutual Company's property and casualty insurance business, including the business reinsured from Southern, written or in force on or after October 1, 1986 is also included in the pooled business. The Mutual Company retroceded 35% of the pooled business to Atlantic States and retained 65% until October 1, 1988 when Atlantic States assumed 50% of the pooled business written or in force on or after October 1, 1988. Effective January 1, 1993, Atlantic States assumed 60% of the pooled business written or in force on or after January 1, 1993, and, effective January 1, 1996, Atlantic States assumed 65% of the pooled business written or in force on or after January 1, 1996. All premiums, losses, loss expenses, other underwriting expenses and policy dividends are prorated among the parties on the basis of their

participation in the pool. The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties. The Company does not intend to terminate its participation in the pooling agreement. The allocations of pool participation percentages between the Mutual Company and the Company are based on the pool participants' relative amounts of capital and surplus and expectations of future relative amounts of capital and surplus. The pooling agreement does not legally discharge Atlantic States from its primary liability for the full amount of the policies ceded. However, it makes the Mutual Company liable to Atlantic States to the extent of the business ceded.

All of DGI's officers are officers of the Mutual Company, and five of DGI's seven directors are directors of the Mutual Company. A Coordinating Committee, which consists of two outside directors from each of DGI and the Mutual Company, none of whom hold seats on both Boards, reviews and approves changes in the pooling agreement and is responsible for matters involving actual or potential conflicts of interest. The decisions of the Coordinating Committee are binding on the two companies. DGI's members must conclude that intercompany transactions are fair and reasonable in order for such transactions to be approved.

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

In addition to the underwriting pool, through the Retrocessional Reinsurance Agreements with each of Delaware Atlantic, Southern and Pioneer, the Mutual Company agreed to indemnify each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and retrocede 100% of the net liability back to each Affiliate, which the Affiliate assumes as part of the retrocession.

DGI's Business Strategy

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

- A regional company concept designed to provide the advantages of local marketing, underwriting and claims servicing with the economies of scale from centralized accounting, administrative, investment, data processing and other services.

- An underwriting program and product mix designed to produce a Company-wide underwriting profit, i.e., a combined ratio of less than 100%, from careful risk selection and adequate pricing.

- A goal of a closely balanced ratio between commercial business and personal business.

- An agent selection process that focuses on appointing agencies with proven market strategies for the development of profitable business and an agent compensation plan providing for additional commissions based upon premium volume and profitability and the right to participate in the Company's Agency Stock Purchase Plan.

- Gradual expansion into adjacent states, including Indiana, Ohio, New York, Tennessee and North Carolina.

- A continuing effort to attract and retain qualified employees who receive incentive compensation based upon historical results.

Property and Casualty Insurance Products and Services

The following table indicates the percentage of DGI's net premiums written represented by commercial lines and by personal lines for the years ended December 31, 1996, 1995 and 1994:

| | Year Ended December 31 | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| Net Premiums Written: | | | |
| Commercial | 45.2% | 46.8% | 43.6% |
| Personal | 54.8 | 53.2 | 56.4 |

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

Commercial

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

- Workers' compensation -- policies purchased by employers to provide benefits to employees for injuries sustained during employment. The extent of coverage

is established by the workers' compensation laws of each state.

- Commercial multi-peril -- policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.

Personal

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

- Homeowners -- policies that provide coverage for damage to residences and their contents from a broad range of perils, including, fire, lightning, windstorm and theft. These policies also cover liability of the insured arising from injury to other persons or their property while on the insured's property and under other specified conditions.

The following table sets forth the combined ratios of DGI, prepared in accordance with generally accepted accounting principles and statutory accounting principles prescribed or permitted by state insurance authorities. The combined ratio is a traditional measure of underwriting profitability. When the combined ratio is under 100%, underwriting results are generally considered profitable. Conversely, when the combined ratio is over 100%, underwriting results are generally considered unprofitable. The combined ratio does not reflect investment income, federal income taxes or other non-operating income or expense. DGI's operating income depends on income from both underwriting operations and investments.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| GAAP Combined Ratio..... | 99.4% | 97.3% | 101.7% |
| Statutory operating ratios: | | | |
| Loss ratio..... | 67.7 | 65.6 | 68.9 |
| Expense ratio..... | 30.9 | 31.6 | 31.3 |
| Dividend ratio..... | 1.5 | 1.2 | 1.7 |
| Statutory combined ratio... | 100.1 | 98.4 | 101.9 |
| Industry statutory combined ratio..... | 107.0(1) | 105.0(2) | 109.6(2) |

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(1) Source: A.M. Best Co.

(2) Source: Insurance Information Institute

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

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| | (in thousands) | | |
| Net Premiums Written: | | | |
| Commercial: | | | |
| Automobile | $ 10,149 | $ 8,306 | $ 6,133 |
| Workers' compensation | 17,327 | 17,607 | 15,110 |
| Commercial multi-peril | 16,975 | 14,598 | 11,028 |
| Other | 2,823 | 2,422 | 2,251 |
| Total commercial | 47,274 | 42,933 | 34,522 |
| Personal: | | | |
| Automobile | 36,331 | 31,060 | 29,263 |
| Homeowners | 18,008 | 14,932 | 12,850 |
| Other | 3,057 | 2,746 | 2,598 |
| Total personal | 57,396 | 48,738 | 44,711 |
| Total business | $104,670 | $91,671 | $79,233 |
| Statutory Combined Ratios: | | | |
| Commercial: | | | |
| Automobile | 97.6% | 92.9% | 116.1% |
| Workers' compensation | 66.6 | 76.9 | 80.0 |
| Commercial multi-peril | 106.5 | 110.0 | 95.0 |
| Other | 65.1 | 88.2 | 92.4 |
| Total commercial | 87.0% | 91.6% | 92.0% |

| | | | |
|---|---|---|---|
| Personal: | | | |
| Automobile | 99.9% | 98.7% | 92.3% |
| Homeowners | 136.4 | 118.7 | 147.5 |
| Other | 99.6 | 90.8 | 111.4 |
| Total personal | 111.2% | 104.1% | 109.3% |
| Total business | 100.1% | 98.4% | 101.9% |

Property and Casualty Underwriting

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

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

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

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

Marketing

DGI's insurance products, together with the products of the Mutual Company and their respective subsidiaries, are marketed through approximately 2,300 independent insurance agents associated with approximately 700 insurance agencies. Business is written by either DGI or the Mutual Company depending upon geographic location, agency license and product. Management has developed an agency appointment procedure that focuses on appointing agencies with proven marketing strategies for the development of profitable business. DGI regularly evaluates its agency force and continues to strive to obtain and retain a significant position within each agency relative to the amount of business similar to that of DGI placed by the agency with other insurers. DGI and the Mutual Company have developed a successful contingent commission plan for agents under which additional commissions are payable based upon the volume of premiums produced and the profitability of the business of the agency written

by DGI and the Mutual Company. Management believes the contingent commission program and the Company's Agency Stock Purchase Plan have enhanced the ability of DGI and the Mutual Company to write profitable business.

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

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

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

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

Claims

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

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

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

Liabilities for Losses and Loss Expenses

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

DGI maintains liabilities for the eventual payment of losses and loss expenses with respect to both reported and unreported claims. Liabilities for loss expenses are intended to cover the ultimate costs of settling all losses, including investigation and litigation costs from such losses. The amount of liability for reported losses is primarily based upon a case-by-case evaluation of the type of risk involved and knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. The amount of liability for unreported claims and loss expenses is determined on the basis of historical information by line of insurance. Inflation is implicitly provided for in the reserving function through analysis of costs, trends and reviews of historical reserving results. Liabilities are closely monitored and are recomputed periodically by the Company and the Mutual Company using new information on reported claims and a variety of statistical techniques. Liabilities for losses are not discounted.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that the ultimate liability will not exceed DGI's loss and loss expenses and have an adverse effect on DGI's results of operations and financial condition. As is the case for virtually all property and casualty insurance companies, DGI has found it necessary in the past to revise in non-material amounts estimated future liabilities for losses and loss expenses, and further adjustments could be required in the future. However, on the basis of DGI's internal procedures, which analyze, among other things, DGI's experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, management of DGI believes that adequate provision has been made for DGI's liability for loss and loss expenses.

Differences between liabilities reported in DGI's financial statements prepared on the basis of generally accepted accounting principles and financial statements prepared on a statutory accounting basis result from reducing statutory liabilities for anticipated salvage and subrogation recoveries. These differences amounted to $4,918,547, $3,880,621 and $2,730,112 at December 31, 1996, 1995 and 1994, respectively.

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

| | Year Ended December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| | | (in thousands) | |
| Net liability for unpaid losses and loss expenses at beginning of year | $70,041 | $62,577 | $52,298 |
| Acquisition of Delaware Atlantic | --- | --- | 5,670 |
| New balance beginning of year | 70,041 | 62,577 | 57,968 |
| Provision for net losses and loss expenses for claims incurred in the current year | 69,206 | 58,354 | 55,941 |
| Increase (decrease) in provision for estimated net losses and loss expenses for claims incurred in prior years | (2,595) | (2,947) | (3,084) |
| Total incurred | 66,611 | 55,407 | 52,857 |
| Net losses and loss payments for claims incurred during: | | | |
| The current year | 39,988 | 28,834 | 30,544 |
| Prior years | 22,889 | 19,009 | 17,704 |
| Total paid | 62,877 | 47,943 | 48,248 |
| Net liability for unpaid losses and loss expenses at end of year | $73,774 | $70,040 | $62,577 |

The following table sets forth the development of the liability for net unpaid losses and loss expenses for DGI on a GAAP basis from 1987 (the first full year of DGI's operations) to 1996, with supplemental loss data for 1996 and 1995.

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

The "Liability reestimated as of" portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate is increased or decreased as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 1990 liability has developed an excess after six years, in that reestimated net losses and loss expenses are expected

to be less than the estimated liability initially established in 1990 of $31,898,000 by $2,303,000.

The "Cumulative deficiency (excess)" shows the cumulative deficiency or excess at December 31, 1996 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or were reevaluated at less than the original amount. A deficiency in liability means that the liability established in prior years was less than actual net losses and loss expenses or were reevaluated at more than the original amount.

The "Cumulative amount of liability paid through" portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 1990 column indicates that as of December 31, 1996, payments equal to $28,157,000 of the currently reestimated ultimate liability for net losses and loss expenses of $29,595,000 had been made.

| | Year Ended December 31 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
| | (in thousands) | | | | | | | | | |
| Net liability at end of year for unpaid losses and loss expenses .... | $ 11,878 | $ 20,734 | $ 27,767 | $ 31,898 | $ 36,194 | $ 43,449 | $ 52,298 | $ 62,577 | $ 70,040 | $ 73,774 |
| Net liability reestimated as of: | | | | | | | | | | |
| One year later ..... | 12,678 | 21,598 | 29,175 | 32,923 | 37,514 | 44,713 | 50,223 | 59,630 | 67,445 | |
| Two years later .... | 12,949 | 20,475 | 28,861 | 33,550 | 37,765 | 42,053 | 47,820 | 56,123 | | |
| Three years later .. | 12,692 | 19,823 | 28,545 | 32,803 | 35,446 | 40,077 | 44,674 | | | |
| Four years later ... | 12,160 | 19,296 | 27,717 | 31,004 | 33,931 | 37,791 | | | | |
| Five years later ... | 11,799 | 18,796 | 26,759 | 30,041 | 32,907 | | | | | |
| Six years later .... | 11,857 | 18,457 | 26,180 | 29,595 | | | | | | |
| Seven years later .. | 11,782 | 18,189 | 25,971 | | | | | | | |
| Eight years later .. | 11,722 | 18,117 | | | | | | | | |
| Nine years later ... | 11,655 | | | | | | | | | |
| Cumulative deficiency (excess) ..... | $ (223) | $ (2,617) | $ (1,796) | $ (2,303) | $ (3,287) | $ (5,658) | $ (7,624) | $ (6,454) | $ (2,595) | |
| Cumulative amount of liability paid through: | | | | | | | | | | |
| One year later ..... | $ 5,891 | $ 8,855 | $ 11,401 | $ 13,003 | $ 13,519 | $ 16,087 | $ 15,947 | $ 19,009 | $ 22,889 | |
| Two years later ..... | 8,472 | 12,280 | 17,421 | 19,795 | 20,942 | 24,010 | 25,128 | 29,892 | | |
| Three years later ... | 9,988 | 14,912 | 20,986 | 24,178 | 25,308 | 28,802 | 31,837 | | | |
| Four years later .... | 10,774 | 16,292 | 23,268 | 26,413 | 27,826 | 32,368 | | | | |
| Five years later .... | 11,209 | 17,201 | 24,331 | 27,439 | 29,605 | | | | | |
| Six years later ..... | 11,388 | 17,706 | 24,909 | 28,157 | | | | | | |
| Seven years later ... | 11,484 | 17,782 | 25,280 | | | | | | | |
| Eight years later ... | 11,544 | 17,884 | | | | | | | | |
| Nine years later .... | 11,563 | | | | | | | | | |

| | Year Ended December 31 | | | | |
|---|---|---|---|---|---|
| | 1992 | 1993 | 1994 | 1995 | 1996 |
| Gross liability at end of year ..... | $ 55,870 | $ 69,442 | $ 87,744 | $ 97,733 | $110,023 |
| Reinsurance recoverable ..... | 12,421 | 17,144 | 25,167 | 27,693 | 36,248 |
| Net liability at end of year ..... | 43,449 | 52,298 | 62,577 | 70,040 | 73,775 |
| Gross reestimated liability -- latest | 57,534 | 63,006 | 80,472 | 93,852 | |
| Reestimated recoverable -- latest ... | 19,743 | 18,332 | 24,349 | 26,407 | |
| Net reestimated liability -- latest . | 37,791 | 44,674 | 56,123 | 67,445 | |
| Gross cumulative deficiency (excess) | 1,664 | (6,436) | (7,272) | (3,881) | |

Reinsurance

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

The external reinsurance purchased by DGI and the Mutual Company includes "excess treaty reinsurance" under which losses are automatically reinsured over a set retention ($250,000 for 1996) and "catastrophic reinsurance" under which the reinsured recovers 90% of an accumulation of many losses resulting from a single event, including natural disasters (for 1996, $3,000,000 retention), DGI's principal reinsurance agreement, other than that with the Mutual Company, is an excess of loss treaty in which the reinsurers are Continental Casualty Company, Employers Reinsurance Corporation and Dorinco Reinsurance Company. Reinsurance is also purchased on an individual policy basis to reinsure losses that may occur from large risks, specific risk types or specific locations. The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risk being reinsured. For property insurance, excess of loss treaties provide for coverage up to $1,000,000. For liability insurance, excess of loss treaties provide for coverage up to $30,000,000. Property catastrophe contracts provide coverage up to $50,000,000 resulting from one event. On both property and casualty insurance, DGI and the Mutual Company purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their respective treaty reinsurance. In addition, the Company and the Mutual Company maintain various reinsurance agreements between themselves in addition to the pooling agreement. Atlantic States and the Mutual Company have a catastrophe reinsurance agreement which limits the maximum liability for losses from any one catastrophe occurrence to $400,000 for Atlantic States and $700,000 for a catastrophe involving more than one of the Company's subsidiaries. Southern and the Mutual Company have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $150,000 for losses in excess of $100,000. Southern and the Mutual Company also have a catastrophe reinsurance agreement which limits Southern's liability to $300,000 from any one catastrophe occurrence. Delaware Atlantic and the Mutual Company have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 for losses in excess of $50,000. Delaware Atlantic and the Mutual Company also have a Catastrophe Reinsurance Agreement which limits Delaware Atlantic's liability to $300,000 from any one catastrophe occurrence. Delaware Atlantic and the Mutual Company also have a reinsurance contract whereby Delaware Atlantic cedes 70% of its workers' compensation business to the Mutual Company. Each of Southern, Delaware Atlantic and Pioneer also have a Retrocessional Reinsurance Agreement with the Mutual Company whereby the Mutual Company indemnifies each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and retrocedes 100% of the net liability back to each Affiliate, which the Affiliate assumes as part of the retrocession.

Competition

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

Investments

DGI's return on invested assets is an important element of its financial results. Currently, the investment objective is to maintain a widely diversified fixed maturities portfolio structured to maximize after-tax investment income while minimizing credit risk through investments in high quality instruments. At December 31, 1996, all debt securities were rated investment grade with the exception of one unrated obligation of $250,000, and the investment portfolio did not contain any mortgage loans or any non-performing assets.

The following table shows the composition of the debt securities investment portfolio (at carrying value), excluding short-term investments, by rating as of December 31, 1996:

| | December 31, 1996 | |
|---|---|---|
| Rating(1) | Amount | Percent |
| | (dollars in thousands) | |
| U.S. Treasury and U.S. agency securities(2) | $ 83,645 | 51.9% |
| Aaa or AAA | 43,857 | 27.2 |
| Aa or AA | 25,879 | 16.0 |
| A | 7,442 | 4.6 |
| BBB | 97 | 0.1 |
| Not rated(3) | 250 | 0.2% |
| Total | $161,170 | 100.0% |

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

(2) Includes mortgage-backed securities of $13,542,146.

(3) Represents one unrated obligation of The Lancaster County Hospital Authority Mennonite Home Project, which management of DGI believes to be equivalent to investment grade securities with respect to repayment risk.

DGI invests in both taxable and tax-exempt securities as part of its strategy to maximize after-tax income. Such strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 37.0%, 38.5% and 26.4% of the total investment portfolio at December 31, 1996, 1995 and 1994, respectively.

The following table shows the classification of the investments (at carrying value) of DGI and its subsidiaries at December 31, 1996, 1995 and 1994.

| | December 31 | | | | | |
|---|---|---|---|---|---|---|
| | 1996 | | 1995 | | 1994 | |
| | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total |
| | (dollars in thousands) | | | | | |
| Fixed maturities(1): | | | | | | |
| Held to maturity: | | | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 37,394 | 20.2% | $ 19,676 | 12.2% | $ 14,271 | 9.8% |
| Obligations of states and political subdivisions | 55,989 | 30.2 | 52,081 | 32.3 | 32,110 | 22.1 |
| Corporate securities | 5,767 | 3.1 | 3,816 | 2.4 | 2,994 | 2.1 |
| Mortgage-backed securities | 12,431 | 6.7 | 16,406 | 10.1 | 20,783 | 14.2 |
| Total held to maturity | 111,581 | 60.2 | 91,979 | 57.0 | 70,158 | 48.2 |
| Available for sale: | | | | | | |
| U.S. treasury securities and obligations of U.S. government corporations and agencies | 32,709 | 17.6 | 35,421 | 21.9 | 33,429 | 22.9 |
| Obligations of states and political subdivisions | 12,682 | 6.8 | 10,120 | 6.3 | 6,357 | 4.4 |
| Corporate securities | 3,087 | 1.7 | 4,348 | 2.7 | 3,734 | 2.6 |
| Mortgage-backed securities | 1,111 | 0.6 | 1,758 | 1.1 | 202 | 0.1 |
| Total available for sale | 49,589 | 26.7 | 51,647 | 32.0 | 43,722 | 30.0 |
| Total fixed maturities | 161,170 | 86.9 | 143,626 | 89.0 | 113,880 | 78.2 |
| Equity securities(2) | 3,134 | 1.7 | 3,264 | 2.0 | 4,202 | 2.9 |
| Short-term investments(3) | 21,207 | 11.4 | 14,498 | 9.0 | 27,485 | 18.9 |
| Total investments | $185,511 | 100.0% | $161,388 | 100.0% | $145,567 | 100.0% |

- ----------

(1) The Company accounts for investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting For Certain Investments in Debt and Equity Securities." See

Notes 1 and 3 to the Consolidated Financial Statements incorporated by reference herein. Fixed maturities held to maturity are valued at amortized cost; those fixed maturities available for sale are valued at fair value. Total fair value of fixed maturities held to maturity was $113,461,217 at December 31, 1996. The amortized cost of fixed maturities available for sale was $49,314,520 at December 31, 1996.

(2) Equity securities are valued at fair value. Total cost of equity securities was $2,770,346 at December 31, 1996, $2,954,487 at December 31, 1995 and $4,897,115 at December 31, 1994.

(3) Short-term investments are valued at cost, which approximates market.

The following table sets forth the maturities (at carrying value) in the fixed maturity and short-term investment portfolio at December 31, 1996, December 31, 1995 and December 31, 1994.

| | December 31 | | | | | |
|---|---|---|---|---|---|---|
| | 1996 | | 1995 | | 1994 | |
| | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total |
| | (dollars in thousands) | | | | | |
| Due in:(1) | | | | | | |
| One year or less | $ 12,615 | 7.8% | $ 34,493 | 21.8% | $ 35,803 | 25.3 |
| Over one year through three years | 24,686 | 15.3 | 19,546 | 12.4 | 34,204 | 24.2 |
| Over three years through five years | 20,150 | 12.5 | 9,559 | 6.0 | 5,346 | 3.8 |
| Over five years through ten years | 43,626 | 27.1 | 35,005 | 22.1 | 9,846 | 7.0 |
| Over ten years through fifteen years | 45,500 | 28.2 | 39,172 | 24.8 | 29,665 | 21.0 |
| Over fifteen years | 1,051 | 0.7 | 2,185 | 1.4 | 5,968 | 4.2 |
| Mortgage-backed securities | 13,542 | 8.4 | 18,164 | 11.5 | 20,534 | 14.5 |
| | $161,170 | 100.0% | $158,124 | 100.0% | $141,366 | 100.0% |

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

As shown above, the Company held investments in mortgage-backed securities having a carrying value of $13,542,146 at December 31, 1996. Included in these investments are collateralized mortgage

obligations ("CMOs") with a carrying value of $12,730,101 at December 31, 1996. The Company has attempted to reduce the prepayment risks associated with mortgage-backed securities by investing approximately 87.8%, as of December 31, 1996, of the Company's holdings of CMOs in planned amortization and very accurately defined tranches. Such investments are designed to alleviate the risk of prepayment by providing predictable principal prepayment schedules within a designated range of prepayments. If principal is repaid earlier than originally anticipated, investment yields may decrease due to reinvestment of these funds at lower current interest rates and capital gains or losses may be realized since the book value of securities purchased at premiums or discounts may be different from the prepayment amount.

Investment results of DGI and its subsidiaries for the years ended December 31, 1996, 1995 and 1994 are shown in the following table:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| | (dollars in thousands) | | |
| Invested assets(1) ..... | $175,780 | $155,093 | $134,636 |
| Investment income(2) ..... | 10,316 | 9,270 | 7,778 |
| Average yield ..... | 5.9% | 6.0% | 5.8% |

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

(2) Investment income is net of investment expenses and does not include realized investment gains or losses or provision for income taxes.

A.M. Best Rating

In 1996, the Best rating of the Mutual Company, Atlantic States, Southern and Delaware Atlantic was "A", based upon their respective current financial conditions and historical statutory results of operations. Management believes that this Best rating is an important factor in marketing DGI's products to its agents and customers. Best's ratings are industry ratings based on a comparative analysis of the financial condition and operating performance of insurance companies as determined by their publicly available reports. Best's classifications are A++ and A+ (Superior), A and A- (Excellent), B++ and B+ (Very Good), B and B- (Good), C++ and C+ (Fair), C and C- (Marginal), D (below minimum standards) and E and F (Liquidation). Best's ratings are based upon factors relevant to policyholders and are not directed toward the protection of investors. According to Best, an "excellent" rating is assigned to those companies which, in Best's opinion, have achieved excellent overall performance when compared to the norms of the property and casualty

insurance industry and have generally demonstrated a strong ability to meet policyholder and other contractual obligations.

Regulation

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

In addition to state-imposed insurance laws and regulations, in December 1993 the National Association of Insurance Commissioners (the "NAIC") adopted a new risk-based capital system for assessing the adequacy of statutory capital and surplus which augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 1996, DGI exceeded the required levels of capital. There can be no assurance that the capital requirements applicable to DGI's business will not increase in the future.

The states in which Atlantic States (Pennsylvania, Maryland and Delaware), the Mutual Company (Pennsylvania, Ohio, Maryland, New York, Virginia and Delaware), Southern (Virginia) and Delaware Atlantic (Delaware, Maryland and Pennsylvania) do business have guaranty fund laws under which insurers doing business in such states can be assessed on the basis of premiums written by the insurer in that state in order to fund policyholder liabilities of insolvent insurance companies. Under these laws in general, an insurer is subject to assessment, depending upon its market share of a given line of business, to assist in the payment of policyholder claims against insolvent insurers. The Mutual Company, Atlantic States, Southern and Delaware Atlantic have made accruals for their portion of assessments related to such insolvencies based upon the most current information furnished by the guaranty associations. During the five years ended December 31, 1996, the amount of such insolvency assessments paid by Atlantic States, Southern, the Mutual Company and Delaware Atlantic was not material.

The property and casualty insurance industry has recently received a considerable amount of publicity because of rising insurance costs and the unavailability of insurance. New regulations and legislation are being proposed to limit damage awards, to control plaintiffs' counsel fees, to bring the industry under regulation by the federal government and to control premiums, policy terminations and other policy terms. It is not possible to predict whether, in what form or in what jurisdictions any of these proposals might be adopted or the effect, if any, on the Company.

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

All transactions within the holding company system affecting the Mutual Company and the Company's insurance subsidiaries must be fair and equitable. Approval of the applicable insurance commissioner is required prior to consummation of transactions affecting the control of an insurer. In some states, including Pennsylvania, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company is presumed to be a change in control. These laws also require notice to the applicable insurance commissioner of certain material transactions between an insurer and any person in its holding company system and, in some states, certain of such transactions cannot be consummated without the prior approval of the applicable insurance commissioner.

The Company's insurance subsidiaries are restricted by the insurance laws of their respective states of domicile as to the amount of dividends or other distributions they may pay to the Company without the prior approval of the respective state regulatory authorities. Generally, the maximum amount that may be paid by an insurance subsidiary during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary's statutory capital and surplus as of a certain date, or the net income or net investment income not including realized capital gains of the subsidiary for the preceding year. As of December 31, 1996, amounts available for payment of dividends in 1997 without the prior approval of the various insurance commissioners were $5,410,536 from Atlantic States, $255,480 from Southern and $1,120,952 from Delaware Atlantic. See Note 11 to the Consolidated Financial Statements incorporated by reference herein.

The Mutual Company

The Mutual Company, which was organized in 1889, has a Best rating of A (Excellent). At December 31, 1996, the Mutual Company had admitted assets of $158 million and policyholders' surplus of $75 million. At December 31, 1996, the Mutual Company had no debt and, of its total liabilities of $83 million, reserves for net losses and loss expenses accounted for $48 million and unearned premiums accounted for $21 million. Of the Mutual Company's investment portfolio of $133 million at December 31, 1996, investment-grade bonds accounted for $48 million, cash and short-term investments accounted for $1 million and mortgages accounted for $7 million. At December 31, 1996, the Mutual Company owned 2,621,633 shares of the Company's Common Stock, which were carried on the Mutual Company's books at $54 million. The foregoing financial information is presented on the statutory basis of accounting.

Employees

As of December 31, 1996, the Mutual Company had 376 employees. The Mutual Company's employees provide a variety of services to DGI, Atlantic States, Delaware Atlantic and Southern as well as to the Mutual Company and its subsidiaries.

Item 2. Properties.

DGI shares headquarters with the Mutual Company in a building owned by the Mutual Company. The Mutual Company charges DGI for an appropriate portion of the building expenses under an intercompany allocation agreement which is consistent with the terms of the pooling agreement. The headquarters of the Mutual Company have approximately 82,000 square feet of office space, with an additional 40,000 square feet of office space currently under construction. Southern has a facility of approximately 10,000 square feet in Glen Allen, Virginia which it leases. Delaware Atlantic has a facility of approximately 2,800 square feet in Wilmington, Delaware, which it leases.

Item 3. Legal Proceedings.

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

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

No matter was submitted to a vote of holders of the Company's Common Stock during the fourth quarter of 1996.

Executive Officers of the Company

| Name | Age | Position |
|---|---|---|
| Donald H. Nikolaus | 54 | President and Chief Executive Officer since 1981 |
| William H. Shupert | 70 | Senior Vice President - Underwriting since 1991; Vice President - Underwriting for 18 years prior thereto |
| Ralph G. Spontak | 44 | Senior Vice President since 1991; Chief Financial Officer and Vice President since 1983; Secretary since 1988; KMG Main Hurdman for nine years to 1983 |
| Frank J. Wood | 63 | Vice President - Marketing since 1988; Manager - Marketing for one year prior thereto |
| James B. Price | 61 | Vice President - Claims since 1972 |
| Robert G. Shenk | 44 | Vice President - Claims since 1992 |
| Daniel J. Wagner | 36 | Treasurer since 1993; Controller for five years prior thereto |

## PART II

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

The answer to this Item is incorporated in part by reference to page 24 of the Company's Annual Report to Stockholders for the year ended December 31, 1996, which is included as Exhibit (13) to this Form 10-K Report. As of March 14, 1997, the Company had approximately 363 holders of record of its Common Stock. The Company declared dividends of $.40 per share in 1995 and $44 per share in 1996.

Item 6. Selected Financial Data.

The answer to this Item is incorporated by reference to page 2 of the Company's Annual Report to Stockholders for the year ended December 31, 1996, which is included as Exhibit (13) to this Form 10-K Report.

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

The answer to this Item is incorporated by reference to pages 7 through 9 of the Company's Annual Report to Stockholders for the year ended December 31, 1996, which is included as Exhibit (13) to this Form 10-K Report.

Item 8. Financial Statements and Supplementary Data.

The answer to this Item is incorporated by reference to pages 10 through 23 of the Company's Annual Report to Stockholders for the year ended December 31, 1996, which is included as Exhibit (13) to this Form 10-K Report.

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

None.

## PART III

Item 10. Directors and Executive Officers of the Company.

The answer to this Item with respect to the Company's directors is incorporated by reference to pages 5 through 8 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 17, 1997. The response to this Item with respect to the Company's executive officers is incorporated by reference to Part I of this Form 10-K Report.

Item 11. Executive Compensation.

The answer to this Item is incorporated by reference to pages 10 through 14 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 17, 1997, except for the Compensation Committee Report and the Performance Graph, which are not incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

The answer to this Item is incorporated by reference to pages 2 through 3 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 17, 1997.

Item 13. Certain Relationships and Related Transactions.

The answer to this Item is incorporated by reference to pages 3 through 5 and page 14 of the Company's proxy statement relating to the Company's annual meeting of stockholders to be held April 17, 1997.

PART IV

Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K.

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

(1) Consolidated Financial Statements



(2) Financial Statement Schedules



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

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* Refers to the respective page of Donegal Group Inc.'s 1996 Annual Report to Stockholders. The Consolidated Financial Statements and Notes to Consolidated Financial Statements and Auditor's Report thereon on pages 10 through 23 are incorporated herein by reference.

With the exception of the portions of such Annual Report specifically incorporated by reference in this Item and Items 5, 6, 7 and 8, such Annual Report shall not be deemed filed as part of this Form 10-K Report or otherwise subject to the liabilities of Section 18 of the Securities Exchange Act of 1934.

(3) Exhibits

| Exhibit No. | Description of Exhibits | Reference |
|---|---|---|
| (3)(i) | Certificate of Incorporation of Registrant | (a) |
| (3)(ii) | Amended and Restated By-laws of Registrant | filed herewith |
| (4) | Form of Registrant's Common Stock Certificate | (a) |
| Management Contracts and Compensatory Plans or Arrangements | | |
| (10)(A) | Donegal Mutual Insurance Company Money Purchase Pension Plan and Trust dated March 12, 1985 | (a) |
| (10)(B) | Donegal Mutual Insurance Company Profit Sharing Plan and Trust dated March 12, 1985 | (a) |
| (10)(C) | Donegal Group Inc. Key Executive Incentive Bonus Plan dated September 29, 1986 | (b) |
| (10)(D) | Donegal Group Inc. Employee Stock Purchase Plan, as amended | (b) |
| (10)(E) | Donegal Group Inc. Equity Incentive Plan, as amended | (b) |
| (10)(F) | Donegal Group Inc. Agency Stock Purchase Plan | (i) |
| (10)(G) | Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan | filed herewith |
| (10)(H) | Donegal Group Inc. 1996 Equity Incentive Plan for Directors | filed herewith |
| (10)(I) | Donegal Group Inc. Executive Restoration Plan | filed herewith |

Other Material Contracts
- ------------------------

| | | |
|---|---|---|
| (10)(J) | Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company | (a) |
| (10)(K) | Services Allocation Agreement dated September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company | (a) |
| (10)(L) | Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (a) |
| (10)(M) | Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (c) |
| (10)(N) | Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance Company | (e) |
| (10)(O) | Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (d) |
| (10)(P) | Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (f) |
| (10)(Q) | Credit Agreement dated as of December 29, 1995 between Donegal Group Inc. and Fleet National Bank of Connecticut | (f) |
| (10)(R) | Stock Purchase Agreement dated as of December 21, 1995 between Donegal Mutual Insurance Company and Donegal Group Inc. | (f) |
| (10)(S) | Donegal Group Inc. 1996 Employee Stock Purchase Plan. | (g) |

| | | |
|---|---|---|
| (10)(T) | Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Pioneer Insurance Company. | filed herewith |
| (10)(U) | Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Delaware American Insurance Company. | filed herewith |
| (10)(V) | Reinsurance and Retrocession Agreement dated May 21, 1996 between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia. | filed herewith |
| (13) | 1996 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K report). | filed herewith |
| (20) | Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 17, 1997, provided, however, that the Compensation Committee Report and the Performance Graph shall not be deemed filed as part of this Form 10-K Report | filed herewith |
| (21) | Subsidiaries of Registrant | (h) |
| (23) | Consent of Independent Auditors | filed herewith |
| (27) | Financial Data Schedule | filed herewith |

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(a) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form S-1 Registration Statement No. 33-8533 declared effective October 29, 1986.

(b) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 10-K Report for the year ended December 31, 1986.

(c) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1988.

(d) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1992.

(e) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration

Statement No. 33-67346 declared effective September 29, 1993.

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.

(g) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-1287 filed February 29, 1996.

(h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1995.

(i) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-06787 declared effective August 1, 1996.

SIGNATURES

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

DONEGAL GROUP INC.

Date: March 27, 1997

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

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

| Signature | Title | Date |
|---|---|---|
| /s/Donald H. Nikolaus<br>Donald H. Nikolaus | President and a Director (principal executive officer) | March 27, 1997 |
| /s/Ralph G. Spontak<br>Ralph G. Spontak | Senior Vice President and Secretary (principal financial and accounting officer) | March 27, 1997 |
| Robert S. Bolinger | Director | March , 1997 |
| Thomas J. Finley | Director | March , 1997 |
| /s/Patricia A. Gilmartin<br>Patricia A. Gilmartin | Director | March 27, 1997 |
| /s/Philip H. Glatfelter,II<br>Philip H. Glatfelter, II | Director | March 27, 1997 |
| /s/C. Edwin Ireland<br>C. Edwin Ireland | Director | March 27, 1997 |
| /s/R. Richard Sherbahn<br>R. Richard Sherbahn | Director | March 27, 1997 |

Independent Auditors' Consent and Report on Schedules

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 3, 1997, included the related financial statement schedules as of December 31, 1996, and for each of the years in the three-year period ended December 31, 1996, incorporated by reference in Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We consent to the use of our reports incorporated by reference in the registration statements (Nos. 333-06681, 33-85128 and 33-31287) on Form S-8 of Donegal Group Inc.

KPMG PEAT MARWICK LLP

Harrisburg, Pennsylvania
March 27, 1997

DONEGAL GROUP INC. AND SUBSIDIARIES

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

December 31, 1996

| | Cost | Fair Value | Amount at Which Shown in the Balance Sheet |
|---|---|---|---|
| Fixed Maturities: | | | |
| Held to maturity: | | | |
| United States government and governmental agencies and authorities including obligations of states and political subdivisions | $ 93,383,066 | $ 95,014,669 | $ 93,383,066 |
| All other corporate bonds | 5,766,899 | 6,036,500 | 5,766,899 |
| Mortgage-backed securities | 12,431,197 | 12,410,048 | 12,431,197 |
| Total fixed maturities held to maturity | 111,581,162 | 113,461,217 | 111,581,162 |
| Available for sale: | | | |
| United States government and governmental agencies and authorities including obligations of states and political subdivisions | 45,111,935 | 45,390,594 | 45,390,594 |
| All other corporate bonds | 3,107,680 | 3,087,000 | 3,087,000 |
| Mortgage-backed securities | 1,094,905 | 1,110,949 | 1,110,949 |
| Total fixed maturities available for sale | 49,314,520 | 49,588,543 | 49,588,543 |
| Total fixed maturities | 160,895,682 | 163,049,760 | 161,169,705 |
| Equity Securities: | | | |
| Preferred stocks | | | |
| Public utilities | 500,000 | 507,188 | 507,188 |
| Banks | 812,500 | 825,187 | 825,187 |
| Industrial and miscellaneous | 1,389,000 | 1,349,250 | 1,349,250 |
| Total preferred stocks | 2,701,500 | 2,681,625 | 2,681,625 |
| Common stocks | | | |
| Banks and insurance companies | 8,596 | 395,073 | 395,073 |
| Industrial and miscellaneous | 60,250 | 57,500 | 57,500 |
| Total common stocks | 68,846 | 452,573 | 452,573 |
| Total equity securities | 2,770,346 | 3,134,198 | 3,134,198 |
| Short-term investments | 21,207,503 | 21,207,503 | 21,207,503 |
| Total investments | $184,873,531 | $187,391,461 | $185,511,406 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Balance Sheets
($ in thousands)
December 31, 1996 and 1995

ASSETS

| | 1996 | 1995 |
|---|---|---|
| Investment in subsidiaries (equity method) | $88,594 | $75,236 |
| Short-term investments, at cost, which approximates market | 7 | 1,117 |
| Cash | 427 | 147 |
| Property and equipment | 1,248 | 1,355 |
| Current income taxes | 158 | 341 |
| Loan costs | 246 | 280 |
| Other receivables | 30 | 4 |
| Total assets | $90,710 | $78,480 |

LIABILITIES AND STOCKHOLDERS' EQUITY

| | 1996 | 1995 |
|---|---|---|
| Cash dividends declared to stockholders | $ 493 | $ 428 |
| Accounts payable and accrued expenses | 174 | 317 |
| Deferred income taxes | 266 | 250 |
| Payable to affiliates | -- | 202 |
| Line of credit | 8,500 | 5,000 |
| Total liabilities | 9,433 | 6,197 |
| Stockholders' equity | | |
| Preferred stock, $1.00 par value, authorized 1,000,000 shares, none issued | | |
| Common stock, $1.00 par value, authorized 10,000,000 shares, issued 4,540,569 and 4,326,362 shares and outstanding 4,471,782 and 4,261,314 shares | 4,540 | 4,327 |
| Additional paid-in capital | 37,316 | 35,018 |
| Net unrealized gains on investments | 421 | 819 |

| | | |
|---|---|---|
| Retained earnings, including equity in undistributed net income of subsidiaries ($45,957 and 37,202) | 39,892 | 32,939 |
| Treasury stock at cost | (892) | (820) |
| Total stockholders' equity | 81,277 | 72,283 |
| Total liabilities and stockholders' equity | $90,710 | $78,480 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED FINANCIAL INFORMATION OF PARENT COMPANY

Condensed Statements of Income
($ in thousands)

Years ended December 31, 1996, 1995 and 1994

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Revenues | | | |
| Dividends-subsidiary | $ 0 | $ 900 | $ 900 |
| Lease income | 541 | 491 | 463 |
| Investment income | 31 | 13 | 12 |
| Total revenues | 572 | 1,404 | 1,375 |
| Expenses | | | |
| Operating expenses | 548 | 411 | 418 |
| Interest | 416 | 4 | 10 |
| Total expenses | 964 | 415 | 428 |
| Income (loss) before income tax benefit and equity in undistributed net income of subsidiaries | (392) | 989 | 947 |
| Income tax (benefit) | (533) | (298) | 16 |
| Income before equity in undistributed net income of subsidiaries | 141 | 1,287 | 931 |
| Equity in undistributed net income of subsidiaries | 8,755 | 8,571 | 4,109 |
| Net income | $ 8,896 | $ 9,858 | $ 5,040 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE II - CONDENSED INFORMATION OF PARENT COMPANY

Condensed Statements of Cash Flows
($ in thousands)
Years ended December 31, 1996, 1995 and 1994

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net income | $ 8,896 | $ 9,858 | $ 5,040 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed net income of subsidiaries | (8,755) | (8,571) | (4,109) |
| Change in accounts payable and accrued expenses | (143) | 225 | 22 |
| Depreciation and amortization | 309 | 264 | 257 |
| Change in deferred income tax | 16 | 15 | 21 |
| Change in current income tax receivable | 183 | (332) | (2) |
| Change in other receivables | 8 | (284) | -- |
| Net adjustments | (8,382) | (8,683) | (3,811) |
| Net cash provided by operating activities | 514 | 1,175 | 1,229 |
| Cash flows from investing activities: | | | |
| Net sales (purchases) of short-term investments | 1,110 | (744) | 447 |
| Net purchase of property and equipment | (203) | (279) | (110) |
| Capital contribution to subsidiaries | (5,000) | | |
| Net purchases of long-term investments | -- | -- | (200) |
| Acquisition of Delaware Atlantic | (202) | (5,300) | -- |
| Net cash provided by (used in) investing activities | (4,295) | (6,323) | 137 |
| Cash flows from financing activities: | | | |
| Cash dividends paid | (1,879) | (1,622) | (1,433) |
| Issuance of common stock | 2,512 | 1,723 | 125 |
| Purchase of treasury stock | (72) | -- | -- |
| Line of credit, net | 3,500 | 5,000 | -- |
| Net cash provided by (used in) financing activities | 4,061 | (5,101) | (1,308) |
| Net change in cash | 280 | (47) | 58 |
| Cash beginning | 147 | 194 | 136 |
| Cash ending | $ 427 | $ 147 | $ 194 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

| Segment | Net Earned Premiums | Net Investment Income | Net Losses and Loss Expenses | Amortization of Deferred Policy Acquisition Costs | Other Underwriting Expenses | Net Premiums Written |
|---|---|---|---|---|---|---|
| Year Ended December 31, 1996 | | | | | | |
| Property and casualty | $99,982,042 | $10,285,617 | $66,611,233 | $17,032,000 | $14,174,023 | $104,669,903 |
| Parent | --- | 30,851 | --- | --- | --- | --- |
| | $99,982,042 | $10,316,468 | $66,611,233 | $17,032,000 | $14,174,023 | $104,669,903 |
| Year Ended December 31, 1995 | | | | | | |
| Property and casualty | $86,277,852 | $ 9,256,960 | $55,407,254 | $14,412,000 | $13,049,188 | $91,671,128 |
| Parent | --- | 12,924 | --- | --- | --- | --- |
| | $86,277,852 | $ 9,269,884 | $55,407,254 | $14,412,000 | $13,049,188 | $91,671,128 |
| Year Ended December 31, 1994 | | | | | | |
| Property and casualty | $77,232,889 | $ 7,765,950 | $52,857,302 | $12,055,000 | $12,278,473 | $79,233,963 |
| Parent | --- | 12,214 | --- | --- | --- | --- |
| | $77,232,889 | $ 7,778,164 | $52,857,302 | $12,055,000 | $12,278,473 | $79,233,963 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE III - SUPPLEMENTARY INSURANCE INFORMATION

| Segment | Deferred Policy Acquisition Costs | At December 31, Liability for Losses and Loss Expenses | Unearned Premiums | Other Policy Claims and Benefits Payable |
|---|---|---|---|---|
| 1996 | | | | |
| Property and Casualty | $ 7,837,899 | $110,022,886 | $66,184,188 | $ --- |
| 1995 | | | | |
| Property and casualty | $ 6,902,218 | $ 97,733,851 | $54,377,239 | $ --- |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE IV - REINSURANCE

| | Gross Amount | Ceded To Other Companies | Assumed From Other Companies | Net Amount | Percentage Assumed to Net |
|---|---|---|---|---|---|
| Year Ended December 31, 1996 | | | | | |
| Property and casualty premiums | $45,159,197 | $38,827,050 | $93,649,895 | $99,982,042 | 94% |
| Year Ended December 31, 1995 | | | | | |
| Property and casualty premiums | $40,552,497 | $29,099,448 | $74,824,803 | $86,277,852 | 87% |
| Year Ended December 31, 1994 | | | | | |
| Property and casualty premiums | $35,275,866 | $24,365,441 | $66,322,464 | $77,232,889 | 86% |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

| | Deferred Policy Acquisition Costs | Liability for Losses and Loss Expenses | Discount, if any, Deducted From Reserves | Unearned Premiums |
|---|---|---|---|---|
| At December 31, | | | | |
| 1996 | $ 7,837,899 | $110,022,886 | $ --- | $66,184,188 |
| 1995 | $ 6,902,218 | $ 97,733,851 | $ --- | $54,377,239 |

DONEGAL GROUP INC. AND SUBSIDIARIES

SCHEDULE VI - SUPPLEMENTARY INSURANCE INFORMATION
CONCERNING PROPERTY AND CASUALTY SUBSIDIARIES

| | Net Earned Premiums | Investment Income | Losses and Loss Expenses Related to (1) Current Year | (2) Prior Years | Amortization of Deferred Policy Acquisition Costs | Net Paid Losses and Loss Expenses | Net Premiums Written |
|---|---|---|---|---|---|---|---|
| Year Ended December 31, 1996 | $99,982,042 | $10,285,617 | $69,206,233 | $(2,595,000) | $17,032,000 | $62,877,258 | $10,466,990 |
| Year Ended December 31, 1995 | $86,277,852 | $ 9,256,960 | $58,354,254 | $(2,947,000) | $14,412,000 | $47,943,360 | $91,671,128 |
| Year Ended December 31, 1994 | $77,232,889 | $ 7,765,950 | $55,941,502 | $(3,084,000) | $12,055,000 | $48,248,316 | $79,233,963 |

EXHIBIT INDEX

(Pursuant to Item 601 of Regulation S-K)

| Exhibit No. | Description of Exhibits | Reference |
|---|---|---|
| (3)(i) | Certificate of Incorporation of Registrant | (a) |
| (3)(ii) | Amended and Restated By-laws of Registrant | filed herewith |
| (4) | Form of Registrant's Common Stock Certificate | (a) |
| Management Contracts and Compensatory Plans or Arrangements | | |
| (10)(A) | Donegal Mutual Insurance Company Money Purchase Pension Plan and Trust dated March 12, 1985 | (a) |
| (10)(B) | Donegal Mutual Insurance Company Profit Sharing Plan and Trust dated March 12, 1985 | (a) |
| (10)(C) | Donegal Group Inc. Key Executive Incentive Bonus Plan dated September 29, 1986 | (b) |
| (10)(D) | Donegal Group Inc. Employee Stock Purchase Plan, as amended | (b) |
| (10)(E) | Donegal Group Inc. Equity Incentive Plan, as amended | (b) |
| (10)(F) | Donegal Group Inc. Agency Stock Purchase Plan | (i) |
| (10)(G) | Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan | filed herewith |
| (10)(H) | Donegal Group Inc. 1996 Equity Incentive Plan for Directors | filed herewith |
| (10)(I) | Donegal Group Inc. Executive Restoration Plan | filed herewith |
| Other Material Contracts | | |
| (10)(J) | Tax Sharing Agreement dated September 29, 1986 between Donegal Group Inc. and Atlantic States Insurance Company | (a) |
| (10)(K) | Services Allocation Agreement dated | (a) |

| | | |
|---|---|---|
| | September 29, 1986 between Donegal Mutual Insurance Company, Donegal Group Inc. and Atlantic States Insurance Company | |
| (10)(L) | Proportional Reinsurance Agreement dated September 29, 1986 between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (a) |
| (10)(M) | Amendment dated October 1, 1988 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (c) |
| (10)(N) | Multi-Line Excess of Loss Reinsurance Agreement effective January 1, 1993 between Donegal Mutual Insurance Company, Southern Insurance Company of Virginia, Atlantic States Insurance Company and Pioneer Mutual Insurance Company, and Christiana General Insurance Corporation of New York, Cologne Reinsurance Company of America, Continental Casualty Company, Employers Reinsurance Corporation and Munich American Reinsurance Company | (e) |
| (10)(O) | Amendment dated July 16, 1992 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (d) |
| (10)(P) | Amendment dated as of December 21, 1995 to Proportional Reinsurance Agreement between Donegal Mutual Insurance Company and Atlantic States Insurance Company | (f) |
| (10)(Q) | Credit Agreement dated as of December 29, 1995 between Donegal Group Inc. and Fleet National Bank of Connecticut | (f) |
| (10)(R) | Stock Purchase Agreement dated as of December 21, 1995 between Donegal Mutual Insurance Company and Donegal Group Inc. | (f) |
| (10)(S) | Donegal Group Inc. 1996 Employee Stock Purchase Plan. | (g) |
| (10)(T) | Reinsurance and Retrocession Agreement dated May 21, 1996, between Donegal Mutual Insurance Company and Pioneer Insurance Company. | filed herewith |
| (10)(U) | Reinsurance and Retrocession Agreement dated May 21, 1996, between Donegal Mutual Insurance Company and | filed herewith |

| | | |
|---|---|---|
| | Delaware American Insurance Company. | |
| (10)(V) | Reinsurance and Retrocession Agreement dated May 21, 1996, between Donegal Mutual Insurance Company and Southern Insurance Company of Virginia. | filed herewith |
| (13) | 1996 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K report.) | filed herewith |
| (20) | Proxy Statement relating to the Annual Meeting of Stockholders to be held on April 17, 1997, provided, however, that the Compensation Committee Report and the Performance Graph shall not be deemed filed as part of this Form 10-K Report | filed herewith |
| (21) | Subsidiaries of Registrant | (h) |
| (23) | Consent of Independent Auditors | filed herewith |
| (27) | Financial Data Schedule | filed herewith |

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(a) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form S-1 Registration Statement No. 33-8533 declared effective October 29, 1986.

(b) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 10-K Report for the year ended December 31, 1986.

(c) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1988.

(d) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1992.

(e) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 33-67346 declared effective September 29, 1993.

(f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.

(g) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-1287 filed on February 29, 1996.

(h) Such exhibit is hereby incorporated by reference to the like-described exhibits in Registrant's Form 10-K Report for the year ended December 31, 1995.

(i) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-06787 declared effective August 1, 1996.

AMENDED AND RESTATED
BY-LAWS
of
DONEGAL MUTUAL INSURANCE COMPANY

## Article 1
## COMPANY OFFICE

Section 1.1. Principal Office. The principal office of the Company shall be in Marietta, Pennsylvania.

Section 1.2. Other Offices. The Company may also have offices at such other places as the Board of Directors may from time to time designate or the business of the Company may from time to time require.

## Article 2
## MEMBERSHIP

Section 2.1. Members. Every policyholder of the Company, except a holder of a policy or contract of reinsurance, is a member of the Company while the policy is in force, and is entitled to one vote, and no more, regardless of the amount of insurance held by such policyholder, the number of policies in force in the name of such policyholder or the amount of premiums paid by such policyholder. Policyholder means the person or group of persons identified as the named insured on the declarations page of a policy of insurance of the Company. Membership begins on the effective date of the policy and continues until the earlier of the termination date, cancellation date or lapse date of the policy. In the case of a surety bond, the



principal upon the bond shall be deemed to be the policyholder. In the case of a group policy, the member shall be the holder of the master policy, and the holder of any certificate or contract issued subordinate to such master policy shall not be a member unless it makes specific provision for such membership.

In the event the policyholder consists of more than one named insured, it shall be presumed that the first named insured is entitled to vote on behalf of all the named insureds unless the Company is otherwise notified in writing.

Section 2.2. Rights of Members. Each member shall have such rights as are prescribed by law for members of mutual insurance companies organized under the laws of the Commonwealth of Pennsylvania, the Articles of Agreement of the Company, these By-laws and any policy of insurance issued by the Company and held by the member.

Section 2.3. Limit of Members' Liability. The policies of the Company shall be non-assessable, and members shall have no contingent liability with respect thereto. Members shall not be liable for losses, expenses or any indebtedness of the Company.

## Article 3
## MEMBERS' MEETINGS

Section 3.1. Annual Meetings. The annual meeting of the members shall be held on the third Thursday in February in each year at 9:30 A.M. at the principal office of the Company, 1195 River Road, Marietta, Pennsylvania.

At such annual meeting, the members shall elect successors to the directors whose terms shall expire that year to serve for the

following three years and until their successors shall have been duly elected and qualified or until their earlier resignation or removal. The members also shall transact such other business as may properly be brought before the meeting.

Section 3.2. Nomination and Election of Directors. Nominations by and of a member for election as director shall be filed in writing. Such written nomination shall be directed to the Nominating Committee of the Board of Directors of the Company care of the Secretary of the Company and shall be received in the Company's principal office no less than thirty days prior to the annual meeting of the members at which such election is to be held, and no person not so nominated shall be eligible for election at such meeting or any adjournment thereof.

Section 3.3. Special Meetings. Special meetings of the members for any purpose or purposes may be called at any time by the President of the Company, and shall be called by the Secretary of the Company at the request in writing of a majority of the Board of Directors or at least one-fifth of the members entitled to vote thereat. Any request for a special meeting of the members shall be signed by the person or persons making the request and shall state the purpose or purposes of the proposed meeting. Upon receipt of any such request, it shall be the duty of the Secretary of the Company to call a special meeting of the members to be held at such time, not less than ten nor more than sixty days thereafter, as the Secretary of the Company may fix. If the Secretary of the Company shall neglect or refuse to issue such call within five days from the receipt of such request, the person or persons making the request may do so. Business transacted at any special meeting of the members

shall be limited to the purposes stated in the notice of meeting or a duly executed waiver of notice thereof.

Section 3.4. Notice of Meetings. Public notice of all meetings of the members, stating the place, date and hour, and, in the case of meetings of the members called for the purpose of amending the Articles of Agreement, the purpose or purposes thereof, shall be given by advertisement once a week for four weeks in at least two daily or weekly newspapers published in Lancaster County, Pennsylvania, and in the legal periodical designated by the courts of Lancaster County, Pennsylvania, for the publication of legal notices, and all such four published notices shall occur more than thirty days prior to the date of such meeting, or by circular mailed to the address of each member. Such notices may be given at the discretion of, or in the name of the Board of Directors, the President, any Vice President, the Secretary or any Assistant Secretary of the Company. When a meeting is adjourned, it shall not be necessary to give any notice of the adjourned meeting or of the business to be transacted at the adjourned meeting, other than by announcement at the meeting at which such adjournment is taken.

Section 3.5. Participation in Meetings by Conference Telephone. One or more members may participate in any meeting of the members by means of conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such person or persons shall be counted for purposes of a quorum.

Section 3.6. Quorum of and Action by the Members. The presence, in person, by proxy or by telephonic or similar communications equipment, of three members entitled to cast a vote on

the particular matter shall constitute a quorum for purposes of considering such matter, and, unless otherwise specifically provided by statute, the acts of such members at a duly organized meeting shall be the acts of the members with respect to such matter.

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

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

Section 3.7. Voting. Except as may be otherwise provided by statute or by these By-laws, at every meeting of the members, every policyholder of the Company shall have the right to one vote regardless of the amount of insurance held by the individual, partnership or corporate entity, the number of policies in force or the amount of premiums paid.

When a quorum exists at any meeting, the oral vote of the majority of the members present in person, by proxy or by telephonic or similar communications equipment shall decide any question brought before such meeting, unless the question is one for which, by express provision of statute or of these By-laws, a different vote is

required. Upon demand made by a member at any election of directors before the voting begins, the election shall be by ballot, in which event the vote shall be taken by written ballot, and the judge or judges of election or, if none, the Secretary of the meeting, shall tabulate and certify the results of such vote.

Section 3.8. Quorum and Adjourned Meeting. Notwithstanding Sections 3.6 and 3.7 of these By-laws: (a) Any meeting at which directors are to be elected may be adjourned only from day to day, or for such longer periods not exceeding fifteen days each as the members present and entitled to vote shall direct; and (b) Those members entitled to vote who attend a meeting called for election of directors that has been previously adjourned for lack of a quorum, although less than a quorum as fixed in the By-laws, shall constitute a quorum for the purpose of electing directors.

Section 3.9. Voting by Proxy. Every member entitled to vote at a meeting of the members or to express consent or dissent to Company action in writing without a meeting may authorize another person or persons to act for him by proxy. Every proxy shall be executed in writing or authorized in a policy for insurance by the member or his duly authorized attorney-in-fact and filed with the Secretary of the Company. A proxy may also be authorized in a policy of insurance issued by the Company or may be authorized in an application for insurance for which a policy is issued by the Company. A proxy, unless coupled with an interest, shall be revocable at will, notwithstanding any other agreement or any provision in the proxy to the contrary, but the revocation of a proxy shall not be effective until written notice thereof has been given to the Secretary of the Company. No unrevoked proxy, unless coupled with an interest, shall

be valid after eleven months from the date of its execution. A proxy shall not be revoked by the death or incapacity of the maker, unless, before the vote is counted or the authority is exercised, written notice of such death or incapacity is given to the Secretary of the Company. A proxy shall be deemed to be coupled with an interest if given in connection with a policy of insurance or an application therefor for as long as such insurance policy, or any renewal policy, remains in force.

Section 3.10. Record Date. The Board of Directors may fix a time, not more than sixty nor less than ten days prior to the date of any meeting of the members, as the record date for the determination of the members entitled to notice of, or to vote at, such meeting. In such case, only such members as shall be members on the date so fixed shall be entitled to notice of, or to vote at, such meeting.

Section 3.11. Judges of Election. In advance of any meeting of the members, the Board of Directors may appoint judges of election, who need not be members, to act at such meeting or any adjournment thereof. If judges of election are not so appointed, the chairman of any such meeting may, and on the request of any member or his proxy, shall make such appointment at the meeting. The number of judges shall be one or three judges. If appointed at a meeting on the request of one or more members or proxies, the majority of members present and entitled to vote shall determine whether one or three judges are to be appointed. No person who is a candidate for office shall act as a judge.

The judges of election shall do all such acts as may be proper to conduct the election or vote and such other duties as may be prescribed by statute with fairness to all members and, if requested

by the chairman of the meeting or any member or his proxy, shall make a written report of any matter determined by them and execute a certificate as to any fact found by them. If there are three judges of election, the decision, act or certificate of a majority shall be the decision, act or certificate of all.

## Article 4
## DIRECTORS

Section 4.1. Powers.

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

(b) Specific Powers. Without limiting the general powers conferred by clause (a) hereof and the powers conferred by the Articles of Agreement and these By-laws of the Company, it is hereby expressly declared that the Board of Directors shall have the following powers:

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

(ii) To appoint a person or persons to vote shares of another corporation held and owned by the Company;

(iii) By resolution adopted by a majority of the whole Board of Directors, to designate one or more committees as set forth in Section 4.13 of this Article 4;

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

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

Section 4.2. Number and Terms of Directors. The number of directors which shall constitute the whole Board of Directors shall be not less than seven nor more than twelve. All directors of the Company shall be natural persons not less than 21 years old, shall be members of the Company and two-thirds of the whole Board of Directors shall be citizens of the United States of America. Not less than one third of the whole Board of Directors shall be persons who are not officers or employees of the Company or of any entity controlling, controlled by or under common control with the Company and who are not beneficial owners of a controlling interest in the voting stock of the Company or any such entity. Within the limits above specified, the number of directors shall be determined by resolution of the Board of Directors. Except as hereinafter provided in the case of vacancies, directors shall be elected by the members, and each director shall be elected for a three-year term and until his successor shall be elected, subject to removal as provided by statute.

Section 4.3. Classes. The Board of Directors shall be divided into three classes: Class A, Class B and Class C. Class A shall initially consist of three members whose terms shall expire at the 1993 annual meeting of members. Class B shall initially consist of three members whose terms shall expire at the 1994 annual meeting of members. Class C shall initially consist of two members whose terms shall expire at the 1992 annual meeting of members. At each annual

meeting of members, the successors to the directors of the class whose terms shall expire in that year shall be elected for a term of three years so that the term of office of one class of directors shall expire in each year. The number of directors in each class shall be as nearly equal as possible so that, except for temporary vacancies, the number in any class shall not exceed the number in any other class by more than one.

Section 4.4. Powers and Duties of the Chairman of the Board of Directors. The Board of Directors shall appoint one of their number as a Chairman of the Board who shall preside at all meetings of the Board of Directors and who shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 4.5. Powers and Duties of the Vice Chairman of the Board of Directors. The Board of Directors may, in its discretion, appoint one of its number as a Vice Chairman of the Board of Directors. In the absence of the Chairman of the Board of Directors, the Vice Chairman of the Board of Directors shall preside at all meetings of the Board of Directors. In addition, the Vice Chairman of the Board of Directors shall have such other powers and duties as may be assigned to him from time to time by the Board of Directors.

Section 4.6. Vacancies. Vacancies on the Board of Directors, including vacancies resulting from an increase in the number of directors, shall be filled by a majority of the remaining members of the Board of Directors, though less than a quorum, or by the sole remaining director, as the case may be, irrespective of whether the members of the Company are entitled to elect one or more directors to fill such vacancies or newly created directorships at the next annual meeting of members. Each person so elected shall be a director until

his successor is elected by the members at the annual meeting of members at which the directorship to which he was elected is up for election or at any special meeting of members prior thereto duly called for that purpose.

Section 4.7. Organization Meetings. The organization meeting of each newly elected Board of Directors shall be held immediately following the meeting of members at which such directors were elected without the necessity of notice to such directors to constitute a legally convened meeting and at such time and place as may be fixed by a notice, or a waiver of notice, or a consent signed by all of such directors. At such meeting, the Board of Directors shall elect the officers of the Company provided for in Article 6 of these By-laws.

Section 4.8. Regular Meetings. The Board of Directors shall have the power to fix by resolution the place, date and hour of regular meetings of the Board of Directors. The Board of Directors shall hold at least four regularly scheduled quarterly meetings during each calendar year.

Section 4.9. Special Meetings. Special meetings of the Board of Directors may be called by the President of the Company on one day's notice to each director, either personally or by mail, telephone or telegram. Special meetings of the Board of Directors shall be called by the President or the Secretary of the Company in like manner and on like notice upon the written request of any five directors. Any action without a meeting of the Board shall be limited to those situations where time is of the essence and not in lieu of a regularly scheduled meeting.

Section 4.10. Notices of Meetings. All meetings of the Board of Directors may be held at such times and places as may be specified in the notice of meeting or in a duly executed waiver of notice thereof. Notice of regular meetings of the Board of Directors shall be given to each director at least three days before each meeting either personally or by mail, telegram or telephone. One or more directors may participate in any meeting of the Board of Directors, or of any committee thereof, by means of a conference telephone or similar communications equipment which enables all persons participating in the meeting to hear one another, and such participation in a meeting shall constitute presence in person at the meeting.

Section 4.11. Quorum. At all meetings of the Board of Directors, the presence, in person or by telephonic or similar communications equipment, of not less than five members of the Board of Directors, including at least one member who is not an officer or employee of the Company or any entity controlling, controlled by or under common control with the Company and who is not the beneficial owner of a controlling interest in the voting stock of the Company or any such entity, shall constitute a quorum for the transaction of business, and the acts of a majority of the directors present at a duly convened meeting at which a quorum is present shall be the acts of the Board of Directors, except as may be otherwise specifically provided by statute, by the Articles of Agreement of the Company or by these By-laws. If a quorum shall not be present, in person or by telephonic or similar communications equipment, at any meeting of the Board of Directors, the directors present may adjourn the meeting

from time to time, without notice other than announcement at the meeting, until a quorum shall be so present.

Section 4.12. Compensation. Directors, as such, may receive a stated salary for their services, or a fixed sum and expenses for attendance at regular or special meetings of the Board of Directors, or any committee thereof, or any combination of the foregoing as may be determined from time to time by resolution of the Board of Directors, and nothing contained herein shall be construed to preclude any director from serving the Company in any other capacity and receiving compensation therefor.

Section 4.13. Committees of the Board of Directors.

(a) Committees. The Board of Directors, by vote of a majority of the whole Board of Directors, may from time to time designate committees of the Board of Directors as specifically provided for herein and such other committees as the Board of Directors may, in its discretion, determine from time to time, with such lawfully delegable powers and duties as the Board of Directors thereby confers, to serve at the pleasure of the Board of Directors and shall, for each such committee, appoint no less than three directors to serve as members and designate, if it desires, one or more directors as alternate members who may replace any absent or disqualified member at any meeting of a committee. At any meeting of any committee so appointed, a quorum shall be determined as provided in Section 4.11 of these By-laws with the members of the committee being substituted for the Board of Directors. At least one third of the total number of the members of each committee so appointed shall be persons who are not officers or employees of the Company or any entity controlling, controlled by or under common control with the

Company and who are not the beneficial owners of a controlling interest in the voting stock of the Company or any such entity. In the absence or disqualification of any member of any committee and any alternate member in his place, the member or members of the committee present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the Board of Directors to act at the meeting in the place of any such absent or disqualified member. The Board of Directors may, from time to time, suspend, alter, continue or terminate any committee or the powers and functions thereof.

(b) Executive Committee. Subject to the requirements of paragraph (a) hereof, the Executive Committee shall consist of the President of the Company and no fewer than two other members of the Board of Directors. The Executive Committee shall have the power to exercise the authority of the full Board of Directors in the management of all business of the Company between meetings of the Board of Directors to the extent consistent with Pennsylvania law. It shall report to the Board of Directors actions taken in the exercise of such power.

(c) Audit Committee. Subject to the requirements of paragraph (a) hereof, the Audit Committee shall consist of no fewer than three members of the Board of Directors, none of whom shall be an officer or employee of the Company or of any entity controlling, controlled by or under common control with the Company and who are not beneficial owners of a controlling interest in the voting stock of the Company or any such entity. The Audit Committee shall recommend the selection of independent certified public accountants and review

the scope and results of the independent audit and the management recommendations made by the independent auditor.

(d) Nominating Committee. Subject to the requirements of paragraph (a) hereof, the Nominating Committee shall consist of no fewer than three members of the Board of Directors, none of whom shall be an officer or employee of the Company or of any entity controlling, controlled by or under common control with the Company and who are not beneficial owners of a controlling interest in the voting stock of the Company or any such entity. The Nominating Committee shall nominate persons for election for director by policyholders and shall review and report on the qualifications of candidates otherwise nominated for director. The President of the Company shall be an ex-officio member of the Nominating Committee.

(e) Compensation Committee. Subject to the requirements of paragraph (a) hereof, the Compensation Committee shall consist of no fewer than three members of the Board of Directors, none of whom shall be an officer or employee of the Company or of any entity controlling, controlled by or under common control with the Company and who are not beneficial owners of a controlling interest in the voting stock of the Company or any such entity. The Compensation Committee shall evaluate the performance of officers deemed to be executive officers of the Company and recommend to the Board of Directors compensation of the executive officers. The President of the Company shall attend all meetings of the Compensation Committee.

## Article 5
## LIABILITY OF DIRECTORS

Section 5.1. Fiduciary Duty. A director of the Company shall stand in a fiduciary relation to the Company and shall perform his duties as a director, including his duties as a member of any committee of the Board of Directors upon which he may serve, in good faith, in a manner he reasonably believes to be in the best interests of the Company, and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances. In performing his duties, a director shall be entitled to rely in good faith on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following: (a) one or more officers or employees of the Company whom the director reasonably believes to be reliable and competent in the matters presented; (b) legal counsel, public accountants or other persons as to matters which the director reasonably believes to be within the professional or expert competence of such persons or (c) a committee of the Board of Directors upon which he does not serve, duly designated in accordance with law, as to matters within its designated authority, which committee the director reasonably believes to merit confidence. A director shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause his reliance to be unwarranted.

Section 5.2. Pertinent Factors. In discharging the duties of their respective positions, the Board of Directors, committees of the Board of Directors and individual directors may, in considering the best interests of the Company, consider the effects of any action

upon employees, suppliers and customers of the Company and communities in which offices or other establishments of the Company are located, and all other pertinent factors. The consideration of these factors shall not constitute a violation of Section 5.1 hereof.

Section 5.3. Presumption of Best Interests. Absent breach of fiduciary duty, lack of good faith or self-dealing, actions taken as a director or any failure to take any action shall be presumed to be in the best interests of the Company.

Section 5.4. No Personal Liability. A director of the Company shall not be personally liable, as such, for monetary damages for any action taken, or any failure to take any action, unless: (a) the director has breached or failed to perform the duties of his office under Sections 5.1 through 5.3 hereof and (b) the breach or failure to perform constitutes self-dealing, willful misconduct or recklessness.

Section 5.5. Exceptions. The provisions of Section 5.4 hereof shall not apply to: (a) the responsibility or liability of a director pursuant to any criminal statute or (b) the liability of a director for the payment of taxes pursuant to local, state or federal law.

Section 5.6. Amendment. Notwithstanding any other provisions of these By-laws, the approval of members shall be required to amend, repeal or adopt any provision as part of these By-laws that is inconsistent with the purpose or intent of Sections 5.1, 5.2, 5.3, 5.4, 5.5 or 5.6 of this Article 5, and, if any such action shall be taken, it shall become effective only on a prospective basis from and after the date of such member approval.

## Article 6
## OFFICERS

Section 6.1. Election and Office. The officers of the Company shall be elected annually by the Board of Directors at its organization meeting and shall consist of a President, a Secretary and a Treasurer. The Board of Directors may also elect one or more Vice Presidents and such other officers and appoint such agents as it shall deem necessary. Each officer of the Company shall hold office for such term, have such authority and perform such duties as set forth in these By-laws or as may from time to time be prescribed by the Board of Directors in consultation with the President. The offices of President, Secretary and Treasurer must be held by different persons.

Section 6.2. Salaries. The salaries of all officers of the Company shall be fixed by the Board of Directors.

Section 6.3. Removal and Vacancies. The Board of Directors may remove any officer or agent elected or appointed at any time and within the period, if any, for which such person was elected or employed whenever in the judgment of the Board of Directors it is in the best interests of the Company, and all persons shall be elected and employed subject to the provisions hereof. If the office of any officer becomes vacant for any reason, the vacancy shall be filled by the Board of Directors, though less than a quorum, or by a sole remaining director, and each person so selected shall be an officer to serve for the balance of the unexpired term.

Section 6.4. Powers and Duties of the President. The President shall be a director of the Corporation. Unless otherwise determined by the Board of Directors, the President shall have the usual duties

of a chief executive officer with general supervision over and direction of the affairs of the Company. In the exercise of these duties and subject to the limitations of the laws of the Commonwealth of Pennsylvania, these By-laws and the actions of the Board of Directors, he may appoint, suspend and discharge employees, agents and officers, may fix the compensation of all officers and assistant officers, shall preside at all meetings of the members at which he shall be present, and, unless there is a Chairman of the Board of Directors or a Vice Chairman of the Board of Directors appointed as provided in Article 4 of these By-laws, shall preside at all meetings of the Board of Directors and shall be a member of all committees. He shall also do and perform such other duties as from time to time may be assigned to him by the Board of Directors.

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

Section 6.5. Powers and Duties of Vice Presidents. Each Vice President shall have such duties as may be assigned to him from time to time by the Board of Directors, the Executive Committee or the President. Any Vice President may, in the discretion of the Board of Directors be designated as "executive", "senior" or by departmental or functional classification. In the event of a temporary absence of the President on vacation or business, the President may designate a

Vice President or Vice Presidents who will perform the duties of the President in such absence. In the event of a prolonged absence of the President due to illness or disability or for any other reason, the Board of Directors shall designate a Vice President or Vice Presidents who will perform the duties of the President during such absence.

Section 6.6. Powers and Duties of the Secretary. The Secretary of the Company shall attend all meetings of the Board of Directors and of the members and shall keep accurate records thereof in one or more minute books kept for that purpose, shall give, or cause to be given, the required notice of all meetings of the members and of the Board of Directors, shall keep in safe custody the seal of the Company and affix the same to any instrument requiring it, and when so affixed, it shall be attested by his signature or by the signature of the Treasurer or any Assistant Secretary or Assistant Treasurer of the Company, and shall perform such other duties as may be assigned to him by the President. The Secretary shall be a director of the Company.

Section 6.7. Powers and Duties of the Treasurer. The Treasurer shall be a natural person of full age. The Treasurer of the Company shall have the custody of the Company's funds and securities, shall keep full and accurate accounts of receipts and disbursements in books belonging to the Company, shall deposit all moneys and other valuable effects in the name and to the credit of the Company in such depositories as shall be designated by the President, shall disburse the funds of the Company as may be ordered by the President or Board of Directors, taking proper vouchers for such disbursements, shall render to the President and the Board of Directors, at the regular

meetings of the Board of Directors or whenever they may require it, an account of all his transactions as Treasurer and of the financial condition of the Company and shall have the right to affix the seal of the Company to any instrument requiring it, and to attest to the same by his signature and, if so required by the Board of Directors, he shall give bond in such sum and with such surety as the Board of Directors may from time to time direct.

Section 6.8. Designation of a Chief Financial Officer. The Board of Directors shall have the power to designate from among the President, any Vice President or the Treasurer of the Company a Chief Financial Officer who shall be deemed the principal financial and accounting officer and who shall have the ultimate responsibility to oversee the financial operation and performance of the Company. In the event that the Treasurer is not designated by the Board of Directors as the Chief Financial Officer, the Treasurer shall report to the Chief Financial Officer from time to time concerning all duties which the Treasurer is obligated to perform and the Chief Financial Officer shall, subject to the reasonable direction of the President or the Board of Directors, at his election, assume such of the duties of the Treasurer as are provided in Section 6.9 hereof as he shall deem appropriate.

## Article 7
## INDEMNIFICATION

Section 7.1. Indemnification. The Company shall indemnify any director or officer, and may indemnify any other employee or agent, who was or is a party to, or is threatened to be made a party to, or who is called as a witness in connection with, any threatened,

pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, including an action by or in the right of the Company, by reason of the fact that he is or was a director, officer, employee or agent of the Company, or is or was serving at the request of the Company as a director, officer, employee or agent of another domestic or foreign corporation for profit or not-for-profit, partnership, joint venture, trust or other enterprise, against expenses, including attorneys' fees, judgments, fines and amounts paid in settlement, actually and reasonably incurred by him in connection with such action, suit or proceeding unless the act or failure to act giving rise to the claim for indemnification is determined by a court to have constituted willful misconduct or recklessness.

Section 7.2. Additional Rights. The indemnification and advancement of expenses provided by, or granted pursuant to, this Article 7 shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any By-law, agreement, contract, vote of members or directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office. It is the policy of the Company that indemnification of, and advancement of expenses to, directors and officers of the Company shall be made to the fullest extent permitted by law. To this end, the provisions of this Article 7 shall be deemed to have been amended for the benefit of directors and officers of the Company effective immediately upon any modification of the Pennsylvania Business Corporation Law of 1988 (the "BCL") or the Insurance Company Law or any modifications, or adoption of any other law that expands or

enlarges the power or obligation of companies governed by the BCL to indemnify or advance expenses to directors and officers of the Company.

Section 7.3. Advances. The Company shall pay expenses incurred by an officer or director, and may pay expenses incurred by any other employee or agent, in defending any action, or proceeding referred to in this Article 7 in advance of the final disposition of such action or proceeding upon receipt of an undertaking by or on behalf of such person to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the Company.

Section 7.4. Term of Indemnification. The indemnification and advancement of expenses provided by or granted pursuant to this Article 7 shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such person.

Section 7.5. Indemnification Fund. The Company shall have the authority to create a fund of any nature, which may, but need not be, under the control of a trustee, or otherwise secure or insure in any manner, its indemnification obligations, whether arising under these By-laws or otherwise. This authority shall include, without limitation, the authority to: (i) deposit funds in trust or in escrow; (ii) establish any form of self insurance; (iii) secure its indemnification obligations by granting a security interest, mortgage or other lien on the assets of the Company or (iv) establish a letter of credit, guarantee or surety arrangement for the benefit of such person in connection with the anticipated indemnification or advancement of expenses contemplated by this Article 7. The

provisions of this Article 7 shall not be deemed to preclude the indemnification of, or the advancement of expenses to, any person who is not specified in Section 7.1 of this Article 7 but whom the Company has the power or obligation to indemnify, or to advance expenses for, under the provisions of the BCL, the Insurance Company Law or otherwise. The authority granted by this Section 7.5 shall be exercised by the Board of Directors of the Company.

Section 7.6. Indemnification by Agreement. The Company shall have the authority to enter into a separate indemnification agreement with any officer, director, employee or agent of the Company or any subsidiary providing for such indemnification of such persons as the Board of Directors shall determine to the fullest extent permitted by law.

Section 7.7. Notice to Company. As soon as practicable after receipt by any person specified in Section 7.1 of this Article 7 of notice of the commencement of any action, suit or proceeding specified in Section 7.1 of this Article 7, such person shall, if a claim with respect thereto may be made against the Company under Article 7 of these By-laws, notify the Company in writing of the commencement or the threat thereof; however, the omission so to notify the Company shall not relieve the Company of any liability under Article 7 of these By-laws unless the Company shall have been prejudiced thereby or from any other liability which it may have to such person other than under Article 7 of these By-laws. With respect to any such action as to which such person notifies the Company of the commencement or threat thereof, the Company may participate therein at its own expense and, except as otherwise provided herein to the extent that it desires, the Company, jointly

with any other indemnifying party similarly notified, shall be entitled to assume the defense thereof, with counsel selected by the Company to the reasonable satisfaction of such person. After notice from the Company to such person of its election to assume the defense, the Company shall not be liable to such person under Article 7 of these By-laws for any legal or other expenses subsequently incurred by such person in connection with the defense thereof otherwise than as provided herein. Such person shall have the right to employ his own counsel in such action, but the fees and expenses of such counsel incurred after notice from the Company of its assumption of the defense thereof shall be at the expense of such person unless: (i) the employment of counsel by such person shall have been authorized by the Company, (ii) such person shall have reasonably concluded that there may be a conflict of interest between the Company and such person in the conduct of the defense of such proceeding or (iii) the Company shall not in fact have employed counsel to assume the defense of such action. The Company shall not be entitled to assume the defense of any proceeding brought by or on behalf of the Company or as to which such person shall have reasonably concluded that there may be a conflict of interest. If indemnification under Article 7 of these By-laws or advancement of expenses are not paid or made by the Company, or on its behalf, within ninety days after a written claim for indemnification or a request for an advancement of expenses has been received by the Company, such person may, at any time thereafter, bring suit against the Company to recover the unpaid amount of the claim or the advancement of expenses. The right to indemnification and advancement of expenses provided hereunder shall be enforceable by

such person in any court of competent jurisdiction. The burden of proving that indemnification is not appropriate shall be on the Company. Expenses reasonably incurred by such person in connection with successfully establishing the right to indemnification or advancement of expenses, in whole or in part, shall also be indemnified by the Company.

Section 7.8. Insurance. The Company shall have the power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the Company, or is or was serving at the request of the Company as a director, officer, employee or agent of another domestic or foreign corporation for profit or not-for-profit, partnership, joint venture, trust or other enterprise against any liability asserted against him or incurred by him in any such capacity, or arising out of his status as such, whether or not the Company would have the power to indemnify him against such liability under the provisions of this Article 7.

Section 7.9. Amendment. Notwithstanding any other provisions of these By-laws, the approval of members shall be required to amend, repeal or adopt any provision as part of these By-laws which is inconsistent with the purpose or intent of this Article 7, and, if any such action shall be taken, it shall become effective only on a prospective basis from and after the date of such member approval.

## Article 8
## FINANCIAL REPORT TO MEMBERS

The President of the Company and the Board of Directors shall present at each annual meeting of the members a full and complete statement of the business and affairs of the Company for the

preceding year. Such statement shall be prepared and presented in whatever manner the Board of Directors shall deem advisable and need not be verified by a certified public accountant or sent to the members of the Company.

## Article 9
## CHECKS AND NOTES

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

## Article 10
## FISCAL YEAR

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

## Article 11
## SEAL

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

## Article 12
## AMENDMENTS

Section 12.1. Amendment by Members. Except as provided in Sections 5.6 and 7.9 hereof, these By-laws may be amended or repealed, and new By-laws adopted, by the affirmative vote of a majority of the votes cast by the members at any regular or special meeting.

Section 12.2. Amendment by Board of Directors. Except as provided in Sections 5.6 and 7.9 hereof, and except as provided in Section 1504(b) of the BCL, these By-laws may be amended or repealed and new By-laws adopted, by the affirmative vote of a majority of the members of the Board of Directors at any regular or special meeting duly convened, subject to the power of the members to change such action of the Board of Directors.

## Article 13
## INTERPRETATION OF BY-LAWS

All words, terms and provisions of these By-laws shall be interpreted and defined by and in accordance with the BCL and the Pennsylvania Insurance Company Law, as the same may be amended from time to time hereafter, and any other applicable Pennsylvania laws, as the same may be amended from time to time hereafter.

As amended through February 20, 1997.

DONEGAL GROUP INC.

AMENDED AND RESTATED
1996 EQUITY INCENTIVE PLAN

1. Purpose. The purpose of the Donegal Group Inc. Amended and Restated 1996 Equity Incentive Plan (the "Plan") is to further the growth, development and financial success of Donegal Group Inc. (the "Company"), its parent and the subsidiaries of the Company and its parent by providing additional incentives to those officers and key employees who are responsible for the management of the business affairs of the Company, its parent and/or subsidiaries of the Company or its parent, which will enable them to participate directly in the growth of the capital stock of the Company. The Company intends that the Plan will facilitate securing, retaining and motivating management employees of high caliber and potential. To accomplish these purposes, the Plan provides a means whereby management employees may receive stock options ("Options") to purchase the Company's Common Stock, $1.00 par value (the "Common Stock").

2. Administration.

(a) Composition of the Committee. The Plan shall be administered by a committee (the "Committee"), which shall be appointed by, and serve at the pleasure of, the Company's Board of Directors (the "Board"). The Committee shall be comprised of two or more members of the Board, each of whom shall be a "non-employee director" within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934 (the "Exchange Act"). In addition, each member of the Committee shall be an "outside director" within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"). Subject to the foregoing, from time to time the Board may increase or decrease the size of the Committee, appoint additional members thereof, remove members (with or without cause), appoint new members, fill vacancies or remove all members of the Committee and thereafter directly administer the Plan.

(b) Authority of the Committee. The Committee shall have full and final authority, in its sole discretion, to interpret the provisions of the Plan and to decide all questions of fact arising in its application; to determine the employees to whom Options shall be granted and the type, amount, size and terms of each such grant; to determine the time when Options shall be granted; and to make all other determinations necessary or advisable for the administration of the Plan. All decisions, determinations and interpretations of the Committee shall be final and binding on all optionees and all other holders of Options granted under the Plan.

(c) Authority of the Board. Notwithstanding anything to the contrary set forth in the Plan, all authority granted hereunder to the Committee may be exercised at any time and from time to time by the Board at its election. All decisions, determinations and interpretations of the Board shall be final and binding on all optionees and all other holders of Options granted under the Plan.



3. Stock Subject to the Plan. Subject to Section 16 hereof, the shares that may be issued under the Plan shall not exceed in the aggregate 695,850 shares of Common Stock. Such shares may be authorized and unissued shares or shares issued and subsequently reacquired by the Company. Except as otherwise provided herein, any shares subject to an Option that for any reason expires or is terminated unexercised as to such shares shall again be available under the Plan.

4. Eligibility To Receive Options. Persons eligible to receive Options under the Plan shall be limited to those officers and other key employees of the Company, its parent and any subsidiary of the Company or its parent (as defined in Section 425 of the Code or any amendment or substitute thereto) who are in positions in which their decisions, actions and counsel significantly impact upon the profitability and success of the Company, its parent or any subsidiary of the Company or its parent. Directors of the Company who are not also officers or employees of the Company, its parent or any subsidiary of the Company or its parent shall not be eligible to participate in the Plan. Notwithstanding anything to the contrary set forth in the Plan, the maximum number of shares of Common Stock for which Options may be granted to any employee in any calendar year shall be 100,000 shares.

5. Types of Options. Grants may be made at any time and from time to time by the Committee in the form of stock options to purchase shares of Common Stock. Options granted hereunder may be Options that are intended to qualify as incentive stock options within the meaning of Section 422 of the Code or any amendment or substitute thereto ("Incentive Stock Options") or Options that are not intended to so qualify ("Nonqualified Stock Options").

6. Option Agreements. Options for the purchase of Common Stock shall be evidenced by written agreements in such form not inconsistent with the Plan as the Committee shall approve from time to time. The Options granted hereunder may be evidenced by a single agreement or by multiple agreements, as determined by the Committee in its sole discretion. Each option agreement shall contain in substance the following terms and conditions:

(a) Type of Option. Each option agreement shall identify the Options represented thereby either as Incentive Stock Options or Nonqualified Stock Options, as the case may be.

(b) Option Price. Each option agreement shall set forth the purchase price

of the Common Stock purchasable upon the exercise of the Option evidenced thereby. Subject to the limitation set forth in Section 6(d)(ii) of the Plan, the purchase price of the Common Stock subject to an Incentive Stock Option shall be not less than 100% of the fair market value of such stock on the date the Option is granted, as determined by the Committee, but in no event less than the par value of such stock. The purchase price of the Common Stock subject to a Nonqualified Stock Option shall be not less than 100% of the fair market value of such stock on the date the Option is granted, as determined by the Committee. For this purpose, fair market value on any date shall mean the closing price of the Common Stock, as reported in The Wall Street Journal, or if not so reported, as otherwise reported by the National Association of Securities Dealers Automated Quotation ("Nasdaq"), or if the Common Stock is not reported by Nasdaq, the fair market value shall be as determined by the Committee pursuant to Section 422 of the Code.

(c) Exercise Term. Each option agreement shall state the period or periods of time within which the Option may be exercised, in whole or in part, as determined by the Committee, provided that no Option shall be exercisable after ten years from the date of grant thereof. The Committee shall have the power to permit an acceleration of previously established exercise terms, subject to the requirements set forth herein, upon such circumstances and subject to such terms and conditions as the Committee deems appropriate.

(d) Incentive Stock Options. In the case of an Incentive Stock Option, each option agreement shall contain such other terms, conditions and provisions as the Committee determines to be necessary or desirable in order to qualify such Option as a tax-favored Option (within the meaning of Section 422 of the Code or any amendment or substitute thereto or regulation thereunder) including without limitation, each of the following, except that any of these provisions may be omitted or modified if it is no longer required in order to have an Option qualify as a tax-favored Option within the meaning of Section 422 of the Code or any substitute therefor:

(i) The aggregate fair market value (determined as of the date the Option is granted) of the Common Stock with respect to which Incentive Stock Options are first exercisable by any employee during any calendar year (under all plans of the Company) shall not exceed $100,000.

(ii) No Incentive Stock Options shall be granted to any employee if at the time the Option is granted to the individual who owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or its subsidiaries unless at the time such Option is granted the Option price is at least 110% of the fair market value of the stock subject to the Option and, by its terms, the Option is not exercisable after the expiration of five years from the date of grant.

(iii) No Incentive Stock Options shall be exercisable more than three months (or one year, in the case of an employee who dies or becomes disabled within the meaning of Section 72(m)(7) of the Code or any substitute therefor) after termination of employment.

(e) Substitution of Options. Options may be granted under the Plan from time to time in substitution for stock options held by employees of other corporations who are about to become, and who do concurrently with the grant of such options become, employees of the Company, its parent or a subsidiary of the Company or its parent as a result of a merger or consolidation of the employing corporation with the Company, its parent or a subsidiary of the Company or its parent, or the acquisition by the Company, its parent or a subsidiary of the Company or its parent of the assets or capital stock of the employing corporation. The terms and conditions of the substitute options so granted may vary from the terms and conditions set forth in this Section 6 to such extent as the Committee at the time of grant may deem appropriate to conform, in whole or in part, to the provisions of the stock options in substitution for which they are granted.

7. Date of Grant. The date on which an Option shall be deemed to have been granted under the Plan shall be the date of the Committee's authorization of the Option or such later date

as may be determined by the Committee at the time the Option is authorized. Notice of the determination shall be given to each individual to whom an Option is so granted within a reasonable time after the date of such grant.

8. Exercise and Payment for Shares. Options may be exercised in whole or in part, from time to time, by giving written notice of exercise to the Secretary of the Company, specifying the number of shares to be purchased. The purchase price of the shares with respect to which an Option is exercised shall be payable in full with the notice of exercise in cash, Common Stock at fair market value, or a combination thereof, as the Committee may determine from time to time and subject to such terms and conditions as may be prescribed by the Committee for such purpose. The Committee may also, in its discretion and subject to prior notification to the Company by an optionee, permit an optionee to enter into an agreement with the Company's transfer agent or a brokerage firm of national standing whereby the optionee will simultaneously exercise the option and sell the shares acquired thereby through the Company's transfer agent or such a brokerage firm and either the Company's transfer agent or the brokerage firm executing the sale will remit to the Company from the proceeds of sale the exercise price of the shares as to which the option has been exercised.

9. Rights upon Termination of Employment. In the event that an optionee ceases to be an employee of the Company, its parent or any subsidiary of the Company or its parent for any reason other than death, retirement, as hereinafter defined, or disability (within the meaning of Section 72(m)(7) of the Code or any substitute therefor), the optionee shall have the right to exercise the Option during its term within a period of three months after such termination to the extent that the Option was exercisable at the time of termination, or within such other period, and subject to such terms and conditions, as may be specified by the Committee. In the event that an optionee dies, retires or becomes disabled prior to the expiration of his Option and without having fully exercised his Option, the optionee or his successor shall have the right to exercise the Option during its term within a period of one year after termination of employment due to death, retirement or disability to the extent that the Option was exercisable at the time of termination, or within such other period, and subject to such terms and conditions, as may be specified by the Committee. As used in this Section 9, "retirement" means a termination of employment by reason of an optionee's retirement at or after his earliest permissible retirement date pursuant to and in accordance with his employer's regular retirement plan or personnel practices. Notwithstanding the provisions of Section 6(d)(iii) hereof, if the term of an Incentive Stock Option continues for more than three months after termination of employment due to retirement or more than one year after termination of employment due to death or disability, such Op tion shall thereupon lose its status as an Incentive Stock Option and shall be treated as a Nonqualified Stock Option.

10. General Restrictions. Each Option granted under the Plan shall be subject to the requirement that, if at any time the Committee shall determine that (i) the listing, registration or qualification of the shares of Common Stock subject or related thereto upon any securities exchange or under any state or federal law, or (ii) the consent or approval of any government regulatory body, or (iii) the satisfaction of any tax payment or withholding obligation, or (iv) an agreement by the recipient of an Option with respect to the disposition of shares of Common

Stock, is necessary or desirable as a condition of or in connection with the granting of such Option or the issuance or purchase of shares of Common Stock thereunder, such Option shall not be consummated in whole or in part unless such listing, registration, qualification, consent, approval or agreement shall have been effected or obtained free of any conditions not acceptable to the Committee.

11. Rights of a Stockholder. The recipient of any Option under the Plan, unless otherwise provided by the Plan, shall have no rights as a stockholder unless and until certificates for shares of Common Stock are issued and delivered to him.

12. Right to Terminate Employment. Nothing contained in the Plan or in any option agreement entered into pursuant to the Plan shall confer upon any optionee the right to continue in the employment of the Company, its parent or any subsidiary of the Company or its parent or affect any right that the Company, its parent or any subsidiary of the Company or its parent may have to terminate the employment of such optionee.

13. Withholding. Whenever the Company proposes or is required to issue or transfer shares of Common Stock under the Plan, the Company shall have the right to require the recipient to remit to the Company an amount sufficient to satisfy any federal, state or local withholding tax requirements prior to the delivery of any certificate or certificates for such shares. If and to the extent authorized by the Committee, in its sole discretion, an optionee may make an election, by means of a form of election to be prescribed by the Committee, to have shares of Common Stock that are acquired upon exercise of an Option withheld by the Company or to tender other shares of Common Stock or other securities of the Company owned by the optionee to the Company at the time of exercise of an Option to pay the amount of tax that would otherwise be required by law to be withheld by the Company as a result of any exercise of an Option. Any such election shall be irrevocable and shall be subject to termination by the Committee, in its sole discretion, at any time. Any securities so withheld or tendered will be valued by the Committee as of the date of exercise.

14. Non-Assignability. No Option under the Plan shall be assignable or transferable by the recipient thereof except by will or by the laws of descent and distribution or by such other means as the Committee may approve. During the life of the recipient, such Option shall be exercisable only by such person or by such person's guardian or legal representative.

15. Non-Uniform Determinations. The Committee's determinations under the Plan (including without limitation determinations of the persons to receive Options, the form, amount and timing of such grants, the terms and provisions of Options, and the agreements evidencing same) need not be uniform and may be made selectively among persons who receive, or are eligible to receive, grants of Options under the Plan whether or not such persons are similarly situated.

16. Adjustments.

(a) Changes in Capitalization. Subject to any required action by the stockholders of the Company, the number of shares of Common Stock covered by each outstanding Option and the number of shares of Common Stock that have been authorized for issuance under the Plan but as to which no Options have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Option, as well as the price per share of Common Stock covered by each such outstanding Option, shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of issued shares of Common Stock effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Committee, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an Option.

(b) Dissolution or Liquidation. In the event of the proposed dissolution or liquidation of the Company, all outstanding Options will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Committee. The Committee may, in the exercise of its discretion in such instances, declare that any Option shall terminate as of a date fixed by the Committee and give each Option holder the right to exercise his Option as to all or any part of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable.

(c) Sale or Merger. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, the Com mittee, in the exercise of its sole discretion, may take such action as it deems desirable, including, but not limited to: (i) causing an Option to be assumed or an equivalent option to be substituted by the successor corporation or a parent or subsidiary of such successor corporation, (ii) providing that each Option holder shall have the right to exercise his Option as to all of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable, or (iii) declaring that an Option shall terminate at a date fixed by the Committee provided that the Option holder is given notice and opportunity to exercise the then exercisable portion of his Option prior to such date.

17. Amendment. The Committee may terminate or amend the Plan at any time, with respect to shares as to which Options have not been granted, subject to any required stockholder approval or any stockholder approval that the Board may deem to be advisable for any reason, such as for the purpose of obtaining or retaining any statutory or regulatory benefits under tax, securities or other laws or satisfying any applicable stock exchange listing requirements. The Committee may not, without the consent of the holder of an Option, alter or impair any Option previously granted under the Plan, except as specifically authorized herein.

18. Reservation of Shares. The Company, during the term of the Plan, will at all times reserve and keep available such number of shares as shall be sufficient to satisfy the requirements of the Plan. Inability of the Company to obtain authority from any regulatory body having jurisdiction, which authority is deemed by the Company's counsel to be necessary to the lawful issuance and sale of any shares hereunder, shall relieve the Company of any liability for the failure to issue or sell such shares as to which such requisite authority shall not have been obtained.

19. Effect on Other Plans. Participation in the Plan shall not affect an employee's eligibility to participate in any other benefit or incentive plan of the Company, its parent or any subsidiary of the Company or its parent. Any Options granted pursuant to the Plan shall not be used in determining the benefits provided under any other plan of the Company, its parent or any subsidiary of the Company or its parent unless specifically provided.

20. Duration of the Plan. The Plan shall remain in effect until all Options granted under the Plan have been satisfied by the issuance of shares, but no Option shall be granted more than ten years after the earlier of the date the Plan is adopted by the Company or is approved by the Company's stockholders.

21. Forfeiture for Dishonesty. Notwithstanding anything to the contrary in the Plan, if the Committee finds, by a majority vote, after full consideration of the facts presented on behalf of both the Company and any optionee, that the optionee has been engaged in fraud, embezzlement, theft, commission of a felony or dishonest conduct in the course of his employment or retention by the Company, its parent or any subsidiary of the Company or its parent that damaged the Company, its parent or any subsidiary of the Company or its parent or that the optionee has disclosed confidential information of the Company, its parent or any subsidiary of the Company or its parent, the optionee shall forfeit all unexercised Options and all exercised Options under which the Company has not yet delivered the certificates. The decision of the Committee in interpreting and applying the provisions of this Section 21 shall be final. No decision of the Committee, however, shall affect the finality of the discharge or termination of such optionee by the Company, its parent or any subsidiary of the Company or its parent in any manner.

22. No Prohibition on Corporate Action. No provision of the Plan shall be construed to prevent the Company or any officer or director thereof from taking any action deemed by the Company or such officer or director to be appropriate or in the Company's best interest, whether or not such action could have an adverse effect on the Plan or any Options granted hereunder, and no optionee or optionee's estate, personal representative or beneficiary shall have any claim against the Company or any officer or director thereof as a result of the taking of such action.

23. Indemnification. With respect to the administration of the Plan, the Company shall indemnify each present and future member of the Committee and the Board against, and each member of the Committee and the Board shall be entitled without further action on his part to indemnity from the Company for, all expenses (including the amount of judgments and the amount of approved settlements made with a view to the curtailment of costs of litigation, other than amounts paid to the Company itself) reasonably incurred by him in connection with or arising out of, any action, suit or proceeding in which he may be involved by reason of his being or

having been a member of the Committee or the Board, whether or not he continues to be such member at the time of incurring such expenses; provided, however, that such indemnity shall not include any expenses incurred by any such member of the Committee or the Board (i) in respect of matters as to which he shall be finally adjudged in any such action, suit or proceeding to have been guilty of gross negligence or willful misconduct in the performance of his duty as such member of the Committee or the Board; or (ii) in respect of any matter in which any settlement is effected for an amount in excess of the amount approved by the Company on the advice of its legal counsel; and provided further that no right of indemnification under the provisions set forth herein shall be available to or enforceable by any such member of the Committee or the Board unless, within 60 days after institution of any such action, suit or proceeding, he shall have offered the Company in writing the opportunity to handle and defend same at its own expense. The foregoing right of indemnification shall inure to the benefit of the heirs, executors or administrators of each such member of the Committee or the Board and shall be in addition to all other rights to which such member may be entitled as a matter of law, contract or otherwise.

24. Miscellaneous Provisions.

(a) Compliance with Plan Provisions. No optionee or other person shall have any right with respect to the Plan, the Common Stock reserved for issuance under the Plan or in any Option until a written option agreement shall have been executed by the Company and the optionee and all the terms, conditions and provisions of the Plan and the Option applicable to such optionee (and each person claiming under or through him) have been met.

(b) Approval of Counsel. In the discretion of the Committee, no shares of Common Stock, other securities or property of the Company or other forms of payment shall be issued hereunder with respect to any Option unless counsel for the Company shall be satisfied that such issuance will be in compliance with applicable federal, state, local and foreign legal, securities exchange and other applicable requirements.

(c) Compliance with Rule 16b-3. To the extent that Rule 16b-3 under the Exchange Act applies to the Plan or to Options granted under the Plan, it is the intention of the Company that the Plan comply in all respects with the requirements of Rule 16b-3, that any ambiguities or inconsistencies in construction of the Plan be interpreted to give effect to such intention and that, if the Plan shall not so comply, whether on the date of adoption or by reason of any later amendment to or interpretation of Rule 16b-3, the provisions of the Plan shall be deemed to be automatically amended so as to bring them into full compliance with such rule.

(d) Effects of Acceptance of Option. By accepting any Option or other benefit under the Plan, each optionee and each person claiming under or through him shall be conclusively deemed to have indicated his acceptance and ratification of, and consent to, any action taken under the Plan by the Company, the Board and/or the Committee or its delegates.

(e) Construction. The masculine pronoun shall include the feminine and neuter, and the singular shall include the plural, where the context so indicates.

25. Stockholder Approval. The exercise of any Option granted under the Plan shall be subject to the approval of the Plan by the affirmative vote of the holders of a majority of the outstanding shares of the Common Stock present, or represented, and entitled to vote at a meeting duly held.

DONEGAL GROUP INC.

1996 EQUITY INCENTIVE PLAN
FOR DIRECTORS

DONEGAL GROUP INC., a corporation organized under the laws of the State of Delaware, hereby sets forth the 1996 Equity Incentive Plan for Directors. The Plan provides for the grant of (i) Options to Outside Directors of the Company and the Mutual Company and (ii) Restricted Stock Awards to Directors of the Company and the Mutual Company, as each of such capitalized terms is hereinafter defined.

1. Definitions. Whenever the following terms are used in the Plan they shall have the meanings specified below unless the context clearly indicates to the contrary:

"Board" shall mean the Board of Directors of the Company.

"Code" shall mean the Internal Revenue Code of 1986, as amended. Reference to a specific section of the Code shall include such section, any valid regulation promulgated thereunder and any comparable provision of any future legislation amending, supplementing or superseding such section.

"Common Stock" shall mean the Common Stock, $1.00 par value, of the Company.

"Company" shall mean Donegal Group Inc., a Delaware corporation.

"Director" shall mean a member of the Board of Directors of the Company and/or the Mutual Company.

"Exchange Act" shall mean the Securities Exchange Act of 1934, as amended.

"Fair Market Value" of the Common Stock on any date shall mean the closing price of the Common Stock for such date, as reported in The Wall Street Journal, or if not so reported, as otherwise reported by the National Association of Securities Dealers Automated Quotation ("Nasdaq") System, or if the Common Stock is not reported by Nasdaq, the fair market value shall be as determined by the Board. If no closing price is reported quoted for such date, the next preceding date for which such sale prices are quoted shall be used.

"Grantee" shall mean a Director to whom a Restricted Stock Award is granted.

"Mutual Company" shall mean Donegal Mutual Insurance Company.



"Option" shall mean a nonqualified stock option granted under the provisions of Section 4 of the Plan to purchase Common Stock of the Company.

"Optionee" shall mean an Outside Director to whom an Option is granted.

"Outside Director" shall mean a Director who is not also an employee of the Company, the Mutual Company or any affiliate of the Company or the Mutual Company.

"Plan" shall mean this 1996 Equity Incentive Plan for Directors.

"Restricted Stock Award" shall mean a restricted stock award granted under the provisions of Section 5 of the Plan.

"Secretary" shall mean the Secretary of the Company.

"Termination of Service" shall mean such time as a Director shall cease to serve as a member of the Board of Directors of the Company or the Mutual Company, whether as a result of resignation, failure to be reelected, removal for cause, death or any other reason.

2. Administration.

(a) Administration by the Board. The Plan shall be administered by the Board.

(b) Duty and Powers of the Board. It shall be the duty of the Board to conduct the general administration of the Plan in accordance with its provisions. The Board shall have the power to interpret the Plan, the Options and the Restricted Stock Awards and to adopt rules for the administration, interpretation and application of the Plan as are consistent therewith and to interpret, amend or revoke any such rules. The Board shall have the discretion to determine who will be granted Options and to determine the number of Options to be granted to any Outside Director, the timing of such grant and the terms of exercise. The Board shall not have any discretion to determine who will be granted Restricted Stock Awards under the Plan.

(c) Board Actions. The Board may act either by vote of a majority of its members present at a meeting of the Board at which a quorum is present or by a memorandum or other written instrument signed by all members of the Board.

(d) Compensation; Professional Assistance; Good Faith Actions. Members of the Board shall not receive any compensation for their services in admin

istering the Plan, but all expenses and liabilities they incur in connection with the administration of the Plan shall be borne by the Company. The Board may employ attorneys, consultants, accountants or other persons. The Board, the Company and

the officers and directors of the Company shall be entitled to rely upon the advice, opinions or valuations of any such persons. All actions taken and all interpretations and determinations made by the Board in good faith shall be final and binding upon all Optionees and Grantees, the Company and all other interested persons. No member of the Board shall be personally liable for any action, determination or interpretation made in good faith with respect to the Plan, and all members of the Board shall be fully protected and indemnified by the Company in respect to any such action, determination or interpretation.

3. Shares Subject to the Plan.

(a) Limitations. The shares of stock issuable pursuant to Options or Restricted Stock Awards shall be shares of the Common Stock. The total number of such shares that may be issued pursuant to Options or Restricted Stock Awards granted under the Plan shall not exceed 90,000 in the aggregate.

(b) Effect of Unexercised or Cancelled Options. If an Option expires or is cancelled for any reason without having been fully exercised or vested, the number of shares subject to such Option that were not purchased or did not vest prior to such expiration or cancellation may again be made subject to an Option or Restricted Stock Award granted hereunder.

(c) Changes in Capitalization. Subject to any required action by the stockholders of the Company, the number of shares of Common Stock covered by each outstanding Option and Restricted Stock Award and the number of shares of Common Stock that have been authorized for issuance under the Plan but as to which no Options or Restricted Stock Awards have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Option, as well as the price per share of Common Stock covered by each such outstanding Option, shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of issued shares of Common Stock effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been "effected without receipt of consideration." Such adjustment shall be made by the Board, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an Option or Restricted Stock Award.

(d) Dissolution or Liquidation. In the event of the proposed dissolution or liquidation of the Company, all outstanding Options will terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the

Board. The Board may, in the exercise of its discretion in such instances, declare that any Option shall terminate as of a date fixed by the Board and give each Option holder the right to exercise his Option as to all or any part of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable.

(e) Sale or Merger. In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, the Board, in the exercise of its sole discretion, may take such action as it deems desirable, including, but not limited to: (i) causing an Option to be assumed or an equivalent option to be substituted by the successor corporation or a parent or subsidiary of such successor corporation, (ii) providing that each Option holder shall have the right to exercise his Option as to all of the shares of Common Stock covered by the Option, including shares as to which the Option would not otherwise be exercisable, or (iii) declaring that an Option shall terminate at a date fixed by the Board, provided that the Option holder is given notice and opportunity to exercise the then exercisable portion of his Option prior to such date.

4. Stock Options.

(a) Granting of Options.

(i) Eligibility. Each Outside Director shall be eligible to be granted Options.

(ii) Granting of Options. Options may be granted by the Board at any time and from time to time while the Plan shall be in effect. The Board shall have the authority to determine the Outside Directors to whom Options are granted, the number of Options to be granted to each and the timing and vesting of each grant. The Board's determinations with respect to Options granted under the Plan need not be uniform and may be made selectively among Outside Directors as the Board, in its discretion, shall determine.

(iii) Type of Options. All Options granted under the Plan shall be options not intended to qualify as incentive stock options under Section 422 of the Code.

(b) Terms of Options.

(i) Option Agreement. Each Option shall be evidenced by a written stock option agreement that shall be executed by the Optionee and on behalf of the Company and that shall contain such terms and conditions as the Board determines are required or appropriate under the Plan.

(ii) Option Price. The exercise price of the shares subject to each Option shall be not less than 100% of the Fair Market Value for such shares on the date the Option is granted.

(iii) Date of Grant. The date on which an Option shall be deemed to have been granted under the Plan shall be the date of the Board's authorization of the Option or such later date as may be determined by the Board at the time the Option is authorized.

(iv) Exercise Term. Each stock option agreement shall state the period or periods of time within which the Option may be exercised, in whole or in part, as determined by the Board, provided that no Option shall be exercisable after ten years from the date of grant thereof. The Board shall have the power to permit an acceleration of previously established exercise terms, subject to the requirements set forth herein, upon such circumstances and subject to such terms and conditions as the Board deems appropriate.

(v) Rights upon Termination of Service. Upon an Optionee's Termination of Service, for any reason other than death, the Optionee shall have the right to exercise the Option during its term within a period of three months after such termination to the extent that the Option was exercisable at the time of termination, or within such other period, and subject to such terms and conditions, as may be specified by the Board. In the event that an Optionee dies prior to the expiration of his Option and without having fully exercised his Option, the Optionee's representative or successor shall have the right to exercise the Option during its term within a period of one year after Termination of Service due to death to the extent that the Option was exercisable at the time of Termination of Service, or within such other period, and subject to such terms and conditions, as may be specified by the Board.

(c) Exercise of Options.

(i) Person Eligible to Exercise. During the lifetime of the Optionee, only the Optionee may exercise an Option or any portion thereof. After the death of the Optionee, any exercisable portion of an Option may be exercised by the Optionee's personal representative or by any person empowered to do so under the deceased Optionee's will or under the then applicable laws of descent and distribution. The Company may require appropriate proof from any such person of such person's right to exercise the Option or any portion thereof.

(ii) Fractional Shares. The Company shall not be required to issue fractional shares on exercise of an Option.

(iii) Manner of Exercise. Options may be exercised in whole or in part, from time to time, by giving written notice of exercise to the Secretary, specifying the number of shares to be purchased. The purchase price of the shares with respect to

which an Option is exercised shall be payable in full with the notice of exercise in cash, Common Stock at Fair Market Value, or a combination thereof, as the Board may determine from time to time and subject to such terms and conditions as may be prescribed by the Board for such purpose. The Board may also, in its discretion and subject to prior notification to the Company by an Optionee, permit an Optionee to enter into an agreement with the Company's transfer agent or a brokerage firm of national standing whereby the Optionee will simultaneously exercise the Option and sell the shares acquired thereby through the Company's transfer agent or such a brokerage firm and either the Company's transfer agent or the brokerage firm executing the sale will remit to the Company from the proceeds of sale the exercise price of the shares as to which the Option has been exercised.

(iv) Rights of Stockholders. An Optionee shall not be, nor have any of the rights of, a stockholder of the Company in respect to any shares that may be purchased upon the exercise of any Option or portion thereof unless and until certificates representing such shares have been issued by the Company to such Optionee.

(v) General Restrictions. Each Option granted under the Plan shall be subject to the requirement that, if at any time the Board shall determine that (i) the listing, registration or qualification of the shares of Common Stock subject or related thereto upon any securities exchange or under any state or federal law, or (ii) the consent or approval of any government regulatory body, or (iii) the satisfaction of any tax payment or withholding obligation, or (iv) an agreement by the Optionee with respect to the disposition of shares of Common Stock, is necessary or desirable as a condition of or in connection with the granting of such Option or the issuance or purchase of shares of Common Stock thereunder, such Option shall not be consummated in whole or in part unless such listing, registration, qualification, consent, approval, payment, withholding or agreement shall have been effected or obtained free of any conditions not acceptable to the Board.

5. Restricted Stock Awards.

(a) Granting of Awards.

(i) Eligibility. Each Director shall be eligible to be granted Restricted Stock Awards.

(ii) Granting of Awards. Each Director shall be granted annual Restricted Stock Awards consisting of 100 shares of Common Stock, such Restricted Stock Awards to be made on the first business day of January in each year, commencing January 2, 1997, provided that the Director served as a member of the Board or of the Board of Directors of the Mutual Company during any portion of the preceding calendar year.

(b) Terms of Restricted Stock Awards.

(i) Restricted Stock Agreement. Each Restricted Stock Award shall be evidenced by a written restricted stock agreement that shall be executed by the Grantee and the Company and that shall contain such restrictions, terms and conditions as are required by the Plan.

(ii) Restrictions on Transfer. The shares of Common Stock comprising the Restricted Stock Awards may not be sold or otherwise transferred by the Grantee until one year after the date of grant. Although the shares of Common Stock comprising each Restricted Stock Award shall be registered in the name of the Grantee, the Company reserves the right to place a restrictive legend on the stock certificate. None of such shares of Common Stock shall be subject to forfeiture.

(iii) Rights as Stockholder.

(A) Subject to the restrictions on transfer set forth in Section 5(b)(ii) hereof, a Grantee shall have all the rights of a stockholder with respect to the shares of Common Stock issued pursuant to Restricted Stock Awards made hereunder, including the right to vote the shares and receive all dividends and other distributions paid or made with respect to the shares.

(B) In the event of changes in the capital stock of the Company by reason of stock dividends, split-ups or combinations of shares, reclassifications, mergers, consolidations, reorganizations or liquidations while the shares comprising a Restricted Stock Award shall be subject to restrictions on transfer, any and all new, substituted or additional securities to which the Grantee shall be entitled by reason of the ownership of a Restricted Stock Award shall be subject immediately to the terms, conditions and restrictions of the Plan.

(C) If a Grantee receives rights or warrants with respect to any shares comprising a Restricted Stock Award, such rights or warrants or any shares or other securities acquired by the exercise of such rights or warrants may be held, exercised, sold or otherwise disposed of by the Grantee free and clear of the restrictions and obligations set forth in the Plan.

(iv) General Restrictions. Each Restricted Stock Award granted under the Plan shall be subject to the requirement that if, at any time the Board shall determine that (i) the listing, registration or qualification of the shares of Common Stock subject or related thereto upon any securities exchange or under any state or federal law, or (ii) the consent or approval of any government regulatory body, or (iii) the satisfaction of any tax payment or withholding obligation, or (iv) an agreement by the Grantee with respect to the disposition of shares of Common Stock, is necessary or desirable as a condition of or in connection with the granting of such Restricted Stock Award, such Restricted Stock Award shall not be consummated in whole or in

part unless such listing, registration, qualification, consent, approval or agreement shall have been effected or obtained free of any conditions not acceptable to the Board.

6. Miscellaneous Provisions.

(a) No Assignment or Transfer. No Option or interest or right therein or part thereof, and, for a period of one year after the date of grant, no Restricted Stock Award or any interest therein or part thereof, shall be liable for the debts, contracts, or engagements of the Optionee or Grantee or his successors in interest nor shall they be subject to disposition by transfer, alienation, anticipation, pledge, encumbrance, assignment or any other means, whether such disposition is voluntary or involuntary or by operation of law by judgment, levy, attachment, garnishment or any other legal or equitable proceedings (including bankruptcy), and any attempted disposition thereof shall be null and void and of no effect; provided, however, that nothing in this Section 6(a) shall prevent transfers by will or by the applicable laws of descent and distribution.

(b) Amendment, Suspension or Termination of the Plan. The Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Board, subject to any required stockholder approval or any stockholder approval that the Board may deem advisable for any reason, such as for the purpose of obtaining or retaining any statutory or regulatory benefits under tax, securities or other laws or satisfying any applicable stock exchange listing requirements. Neither the amendment, suspension nor termination of the Plan shall, without the consent of the Optionee or Grantee, alter or impair any rights or obligations under any outstanding Option or Restricted Stock Award. No Option or Restricted Stock Award may be granted during any period of suspension nor after termination of the Plan.

(c) Withholding. Whenever the Company proposes or is required to issue or transfer shares of Common Stock under the Plan, the Company shall have the right to require the recipient to remit to the Company an amount sufficient to satisfy any federal, state or local withholding tax requirements prior to the delivery of any certificate for such shares. If and to the extent authorized by the Board, in its sole discretion, an Optionee may make an election, by means of a form of election to be prescribed by the Board, to have shares of Common Stock that are acquired upon exercise of an Option withheld by the Company or to tender other shares of Common Stock or other securities of the Company owned by the Optionee to the Company at the time of exercise of an Option to pay the amount of tax that would otherwise be required by law to be withheld by the Company as a result of any exercise of an Option. Any such election shall be irrevocable and shall be subject to termination by the Board, in its sole discretion, at any time. Any securities so withheld or tendered will be valued by the Board as of the date of exercise.

(d) Reservation of Shares. The Company, during the term of the Plan, will at all times reserve and keep available such number of shares as shall be sufficient to satisfy the requirements of the Plan. Inability of the Company to obtain authority from any regulatory body having jurisdiction, which authority is deemed by the Company's counsel to be necessary to the lawful issuance and sale of any shares hereunder, shall relieve the Company of any liability for the failure to issue or sell such shares as to which such requisite authority shall not have been obtained.

(e) Duration of the Plan. The Plan shall remain in effect until all Options granted under the Plan have been satisfied by the issuance of shares, but no Option or Restricted Stock Award shall be granted more than ten years after the earlier of the date the Plan is adopted by the Company or is approved by the Company's stockholders.

(f) No Prohibition on Corporate Action. No provision of the Plan shall be construed to prevent the Company or any officer or director thereof from taking any action deemed by the Company or such officer or director to be appropriate or in the Company's best interest, whether or not such action could have an adverse effect on the Plan or any Options or Restricted Stock Awards granted hereunder, and no Director or Director's estate, personal representative or beneficiary shall have any claim against the Company or any officer or director thereof as a result of the taking of such action.

(g) Indemnification. With respect to the administration of the Plan, the Company shall indemnify each present and future member of the Board against, and each member of the Board shall be entitled without further action on his part to indemnity from the Company for, all expenses (including the amount of judgments and the amount of approved settlements made with a view to the curtailment of costs of litigation, other than amounts paid to the Company itself) reasonably incurred by him in connection with or arising out of, any action, suit or proceeding in which he may be involved by reason of his being or having been a member of the Board, whether or not he continues to be such member at the time of incurring such expenses; provided, however, that such indemnity shall not include any expenses incurred by any such member of the Board (i) in respect of matters as to which he shall be finally adjudged in any such action, suit or proceeding to have been guilty of gross negligence or willful misconduct in the performance of his duty as such member of the Board; or (ii) in respect of any matter in which any settlement is effected for an amount in excess of the amount approved by the Company on the advice of its legal counsel; and provided further that no right of indemnification under the provisions set forth herein shall be available to or enforceable by any such member of the Board unless, within 60 days after institution of any such action, suit or proceeding, he shall have offered the Company in writing the opportunity to handle and defend same at its own expense. The foregoing right of indemnification shall inure to the benefit of the heirs, executors or administrators of each such member of the Board and shall be in addition

to all other rights to which such member may be entitled as a matter of law, contract or otherwise.

(h) Compliance with Plan Provisions. No Optionee or Grantee shall have any right with respect to the Plan, the Common Stock reserved for issuance under the Plan or in any Option or Restricted Stock Award until a written stock option agreement or a written restricted stock agreement, as the case may be, shall have been executed on behalf of the Company and by the Optionee or Grantee, and all the terms, conditions and provisions of the Plan and the Option or Restricted Stock Award applicable to such Optionee or Grantee (and each person claiming under or through him) have been met.

(i) Approval of Counsel. In the discretion of the Board, no shares of Common Stock, other securities or property of the Company or other forms of payment shall be issued hereunder with respect to any Option or Restricted Stock Award unless counsel for the Company shall be satisfied that such issuance will be in compliance with applicable federal, state, local and foreign legal, securities exchange and other applicable requirements.

(j) Effects of Acceptance. By accepting any Option or Restricted Stock Award or other benefit under the Plan, each Optionee and Grantee and each person claiming under or through him shall be conclusively deemed to have indicated his acceptance and ratification of, and consent to, any action taken under the Plan by the Company, the Board or its delegates.

(k) Construction. The masculine pronoun shall include the feminine and neuter, and the singular shall include the plural, where the context so indicates.

(l) Compliance with Rule 16b-3. To the extent that Rule 16b-3 under the Exchange Act applies to Options or Restricted Stock Awards granted under the Plan, it is the intention of the Company that the Plan comply in all respects with the requirements of Rule 16b-3, that any ambiguities or inconsistencies in construction of the Plan be interpreted to give effect to such intention and that if the Plan shall not so comply, whether on the date of adoption or by reason of any later amendment to or interpretation of Rule 16b-3, the provisions of the Plan shall be deemed to be automatically amended so as to bring them into full compliance with such rule.

(m) Stockholder Approval. Except with respect to the Restricted Stock Awards to be granted on January 2, 1997, no Option may be exercised and no Restricted Stock Award may be granted until the Plan shall have been approved by the affirmative vote of the holders of a majority of the shares of the Company's outstanding Common Stock present or represented and entitled to vote at a duly convened meeting of stockholders held on or before December 31, 1997. The failure of the stockholders of the Company to approve the Plan shall in no way terminate or

otherwise impair the Restricted Stock Awards granted to Directors hereunder on January 2, 1997.

(n) Titles. Titles are provided herein for convenience only and are not to serve as a basis for interpretation or construction of the Plan.

DONEGAL MUTUAL INSURANCE COMPANY

EXECUTIVE RESTORATION PLAN

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# DONEGAL MUTUAL INSURANCE COMPANY

## EXECUTIVE RESTORATION PLAN

In recognition of the services provided to Donegal Mutual Insurance Company (the "Employer"), its Board of Directors (the "Board") wishes to restore certain retirement benefits to those individuals (individually an "Employee") for whom contributions to the Donegal Mutual Insurance Company Money Purchase Pension and Profit Sharing Plans (hereinafter together referred to as the "Retirement Plans") are restricted as a result of the application of Sections 401(a)(17) and 415 of the Internal Revenue Code of 1986, as amended (the "Code"). It is the intent of the Board to provide these benefits under the terms and conditions hereinafter set forth.

## SECTION 1

## DEFINITIONS

1.1 Each capitalized term used in this Plan (as hereinafter defined) which is a defined term in either of the Retirement Plans and which is not separately defined in this Plan shall have the same meaning herein as assigned to it under the provisions of the Retirement Plans unless otherwise qualified by the context.

1.2 The following additional defined terms as used herein shall have the following meanings unless a different meaning is required by the context:

1.2.1 "Accrued Benefit" means the balance in a Participant's Individual Account.

1.2.2 "Administrator" means the Employer or any person or committee designated by the Employer to provide for the general administration of this Plan pursuant to Section 9 hereof.

1.2.3 "Annuity Starting Date" means (i) the first day of the first period for which an amount is payable as an annuity or (ii) in the case of a benefit not payable in the form of an annuity, the first day on which all events have occurred which entitle the Participant to the benefit.

1.2.4 "Beneficiary" means the person(s) designated by a Participant to receive any benefits payable under this Plan subsequent to the Participant's death. In the event a Participant has not filed a beneficiary designation with the Employer, the Beneficiary shall be the Participant's surviving spouse or, if there is no surviving spouse, his estate.

1.2.5 "Earliest Retirement Age" means, solely for purposes of Section 1.2.11 hereof, the earliest date on which, under this Plan, the Participant could elect to receive benefits if the Participant terminated employment or any earlier date determined by the Administrator.

1.2.6 "Effective Date" means January 1, 1994.

1.2.7 "Individual Account" means the account established and maintained in accordance with the provisions of Sections 3 and 4 hereof.

1.2.8 "Participant" means any Employee who satisfies the eligibility and other requirements set forth in Section 2 hereof. In the event of the death or the incompetency of a Participant, the term shall mean his or her personal representative or guardian.

1.2.9 "Plan" means the Donegal Mutual Insurance Company Executive Restoration Plan as set forth herein and as it may be amended or supplemented from time to time.

1.2.10 "Plan Year" means the calendar year.

1.2.11 "Qualified Domestic Relations Order" means a judgment, decree or order (including approval of a property settlement agreement) made pursuant to a state domestic relations law (including a community property law) which (a) relates to the provision of child support, alimony payments or marital property rights to a spouse, former spouse, child or other dependent of a Participant (the "Alternate Payee"); (b) creates or recognizes the existence of the Alternate Payee's right to, or assigns to the Alternate Payee the right to, receive all or a portion of the benefits payable to a Participant under this Plan; (c) specifies (i) the name and last known mailing address (if any) of the Participant and each Alternate Payee covered by the order, (ii) the amount or percentage of the Participant's Plan benefits to be paid to the Alternate Payee, or the manner in which such amount or percentage is to be determined, and (iii) the number of payments or the period to which the order applies and each plan to which the order relates; and (d) does not require this Plan to (i) provide any type or form of benefit, or any option not otherwise provided under this Plan, (ii) provide increased benefits, or (iii) pay benefits to the Alternate Payee that are required to be paid to another Alternate Payee under a prior Qualified Domestic Relations Order. Notwithstanding the foregoing, a Qualified Domestic Relations Order may provide that distribution commence on or after the date on which the Participant attains, or would have attained, his Earliest Retirement Age regardless of whether the Participant has terminated service on that date, if the Order directs (i) that the payment of the benefits be determined as if the Participant had retired on the date on which payment is to begin under such Order, taking into account only the balance standing to the Participant's credit in his Individual Account on such date, and (ii)

that the payment be made in any form in which such benefits may be paid under this Plan to the Participant.

1.2.12 "Salary" means a Participant's base salary actually paid to the Participant for the calendar year ending with each Plan Year and shall not include any amounts contributed by the Employer under the Retirement Plans, any amounts paid by the Employer pursuant to this Plan, any form of bonus or incentive compensation and any disability payments, taxable fringe benefits, non-taxable fringe benefits, amounts realized from the exercise of stock options, or when restricted stock (or property) held by the Participant either becomes freely transferable or is no longer subject to a substantial risk of forfeiture, and amounts realized from the sale, exchange or other disposition of stock options shall be excluded from Salary. The foregoing notwithstanding, Salary shall include any amount which is contributed by the Employer pursuant to a salary reduction agreement and which is not includable in the gross income of the Participant under Section 125 or 402(e)(3) of the Code, provided that this provision shall not cause a Participant's Salary to exceed his or her base salary amount in effect before any such reduction.

1.2.13 "Trust" means each of the trusts established pursuant to the Trust Agreement (as defined herein) for the purpose of receiving and holding Plan assets.

1.2.14 "Trust Agreement" means the agreement between the Trustee and the Employer entered into for the purpose of holding, managing and administering all property held by the Trustee for the benefit of each Participant and his or her Beneficiary.

1.2.15 "Trustee" means CoreStates Hamilton Bank or any successor designated by the Employer.

1.2.16 "Valuation Date" means the last day of each Plan Year or such other interim dates which shall be designated as such by the Administrator.

## SECTION 2

## ELIGIBILITY

2.1 Any Employee who is a participant in one or both of the Retirement Plans on the Effective Date and for whom employer contributions have been restricted by reason of the limitations imposed by Section 401(a)(17) or 415 of the Code shall participate in this Plan.

2.2 Following the Effective Date, Employees who are participants in one or both of the Retirement Plans and for whom the amount of their employer contributions is limited by Section 401(a)(17) or 415 of the Code shall automatically become a Participant in this Plan.

2.3 Notwithstanding any other provision of this Section 2 to the contrary, no Employee will be eligible to participate in or receive benefits from this Plan if he or she violates the terms and conditions of any employment contract, service contract, or any other agreement relating to confidential matters of the Employer.

## SECTION 3

## BENEFITS

3.1 The Employer shall create and maintain an Individual Account for each Participant and except as otherwise provided in Sections 3.2 and 3.3 hereof, it shall deposit and credit to the Individual Account of each Participant an amount for each Plan Year that is equal to the sum of (a) and (b) where:

(a) is the amount of the employer contribution that was not contributed to the Donegal Mutual Insurance Company Money Purchase Pension Plan on behalf of the Participant during the corresponding Plan

Year, taking into account the Participant's Salary, as a result of the operation of the limitations set forth in Code Sections 401(a)(17) and 415; and

(b) is the amount of the employer contribution, if any, that would have been allocated to the Donegal Mutual Insurance Company Profit Sharing Plan on behalf of the Participant during the corresponding Plan Year, taking into account the Participant's Salary, but for the limitations set forth in Code Sections 401(a)(17) and 415.

3.2 Notwithstanding the foregoing provisions of Section 3.1 hereof, the sum of (i) the annual additions made to a Participant's accounts under the Retirement Plans with respect to any Plan Year, as determined in accordance with Section 415(b) of the Code, and (ii) the amounts to be deposited and credited to a Participant's Individual Account pursuant to Section 3.1 hereof shall not exceed an amount equal to twenty-five percent (25%) of the Participant's compensation taken into account for purposes of Code Section 415 for such Plan Year. In the event that such limitation would be exceeded with respect to any Plan Year, the amount to be deposited and credited under Sections 3.1(a) and (b) hereof to the Participant's Individual Account shall be reduced to the extent necessary (but not below zero) in order to satisfy the twenty-five percent (25%) limitation.

3.3 In no event shall a Participant's Individual Account be credited with a contribution pursuant to Sections 3.1 (a) and (b) hereof unless the Participant completed at least 1,000 Hours of Service during the Plan Year.

3.4 The payments required by Section 3.1 hereof shall be deemed to have been made on the last day of the Plan Year to which they relate regardless of when actually calculated by the Employer, provided that

such payments shall in no event be made later than sixty (60) days after the end of the Plan Year.

3.5 At such time as the Employer shall determine, in its sole discretion, but in no event later than one month before the latest time prescribed in Section 3.4 hereof for the making of contributions, the Employer shall make a payment available to each Participant with respect to each Plan Year in an amount equal to the sum of (i) the amount required pursuant to this Section 3 to be contributed to the Participant's Individual Account for the Plan Year in accordance with Sections 3.1(a) and (b) hereof (the "Section 3 Payment") and (ii) the amount necessary to pay all applicable federal, state and local income taxes due on the Section 3 Payment (assuming the highest applicable marginal rates (including any surtax rate as well as the Medicare health insurance tax rate imposed on employees under the Federal Insurance Contributions Act) for federal and state purposes and the highest marginal local rate in effect at the Employer's headquarters) so that after the payment of such taxes the Section 3 Payment will have remained intact and will not have had to have been reduced by such taxes (the "Tax Gross-Up"). In accordance with procedures adopted by the Administrator, a Participant may elect to receive the Section 3 Payment and the Tax Gross-Up directly in cash or alternatively may direct the Employer (as his or her agent) to deposit the Section 3 Payment into the Trust on behalf of the Participant and to pay the Tax Gross-Up directly to the Participant. In the event that for any Plan Year a Participant elects to receive the Section 3 payment directly instead of having the Section 3 Payment deposited in the Trust, the Participant shall no longer be entitled to receive any further Tax Gross-Up amounts.

SECTION 4

ACCOUNTS

4.1 In order to implement this Plan, the Employer has entered into a Trust Agreement so that the Plan assets shall be segregated from the Employer's own assets and held in trust for the exclusive benefit of the Participants.

4.2 Apart from a Section 3 payment which a Participant elects to receive pursuant to Section 3.5 hereof, all amounts paid by the Employer pursuant to this Plan shall be paid over to the Trustee. Such amounts and all cash, securities or properties and income therefrom received by the Trustee shall constitute assets of the Trust.

4.3 The Trustee shall have the sole investment responsibility for the assets of the Trust unless the Administrator makes the election provided under Section 4.6 hereof. The execution of the Trust Agreement by the Trustee shall evidence such Trustee's acceptance of his or its fiduciary capacity and agreement to the allocation of fiduciary responsibilities, obligations and duties contained in this Plan and the Trust Agreement.

4.4 Each Individual Account shall constitute a separate trust. The assets of each Trust shall be revalued by the Trustee at each Valuation Date at their market value, taking into account capital appreciation or depreciation in such assets whether or not realized.

4.5 The Administrator shall establish or provide for the establishment of accounting procedures for the purpose of making the allocations, valuations and adjustments to the Individual Accounts provided for in this Section 4.

4.6 Each Participant shall be permitted to direct the Trustee as to the investments or investment media or funds in which the assets

credited to the Participant's Individual Account shall be invested. All such directed investments shall be made and implemented in accordance with the rules and procedures established by the Administrator.

4.7 At the same time that the election is provided for in accordance with Section 3.5 hereof, the Trustee, unless the Trustee receives a Participant waiver of his right to receive an annual distribution of income from his Trust pursuant to Article VI of the Trust Agreement, shall distribute the Trust's income to the Participant in the manner provided in Article VI of the Trust Agreement. Moreover, the annual income from the Trust which must be taken into income by each Participant may, in the sole discretion of the Employer, be the subject of a tax gross-up payment in the same manner as is provided in accordance with Section 3.5 hereof.

## SECTION 5

## DISTRIBUTIONS

5.1 A Participant's Accrued Benefit shall be paid to the Participant within sixty (60) days after the Valuation Date immediately following the date on which his or her employment with the Employer terminates, provided that in no event shall the payment be made before the end of the 45-day election period provided for in Section 5.4(b) hereof unless agreed to by the Participant. If the Participant is entitled to a payment pursuant to Section 3.1 hereof for the Plan Year in which he or she terminates employment, that additional contribution will be paid to him or her along with the Participant's Accrued Benefit.

5.2 A Participant who has a Spouse on his or her Annuity Starting Date shall receive benefits in the form of a joint and survivor annuity

unless pursuant to Section 5.4 hereof he or she elects to receive his or her benefit in another form. Such annuity shall pay monthly retirement benefits to the Participant for life and, after his or her death, to the Participant's Spouse in an amount equal to 50% of the benefit payable to the Participant. The amount of such annuity shall be such as can be obtained with the balance in the Participant's Individual Account on the Annuity Starting Date.

5.3 In the absence of an election pursuant to Section 5.4 hereof a Participant who does not have a Spouse on his or her Annuity Starting Date shall receive a retirement benefit in the form of a single life annuity. Such annuity shall be in the amount which can be obtained with the balance in the Participant's Individual Account on the Annuity Starting Date.

5.4 In lieu of the forms of benefit provided in Sections 5.2 and 5.3 hereof and subject to the spousal consent requirements of Section 5.6 hereof, a Participant may elect to have his or her Accrued Benefit distributed in one or both of the following forms:

(a) a lump sum cash payment; or

(b) five (5) substantially equal, annual cash installments of his or her Accrued Benefit (or such portion which is not received as a lump sum) plus any earnings credited to the Participant's Individual Account as of any payment date following distribution of the initial installment. The election must be made within the 45-day period following the date of the Participant's termination of employment and any such election may be revoked at any time during the election period. The Participant's Individual Account shall continue to be credited with earnings pursuant to Section 4 hereof for so long as there exists any unpaid balance. In the event that the Participant

shall die before receiving all installments elected by the Participant, the balance of such unpaid installments shall be paid in a single sum to the Participant's Beneficiary or, in the absence of such Beneficiary, to the Participant's estate.

5.5 No less than 30 days and no more than 90 days before the Annuity Starting Date, the Administrator shall mail or personally deliver to the Participant a written explanation of (i) the terms and conditions of the normal forms of benefit as described in Sections 5.2 and 5.3 hereof, including (a) a general explanation of the relative financial effect on the Participant's benefit of an election under Section 5.4 to waive the normal form of benefit and to elect an optional form, (b) a general description of the eligibility conditions and other material features of each optional form of benefit and (c) sufficient additional information to explain the relative value of each optional form of benefit available under Section 5.4 hereof, (ii) the Participant's right to elect each optional form of benefit and the effect of such an election, (iii) the rights of the Participant's Spouse under Section 5.6 hereof, and (iv) the right to make, and the effect of, a revocation of an election hereunder.

5.6 If a married Participant elects an optional form of benefit as provided in Section 5.4 hereof, the Spouse of the Participant must consent in writing to the election on a form provided by the Administrator, which consent shall be irrevocable. The consent shall acknowledge the effect of the election on the Spouse's right to benefits under this Plan and shall be witnessed by a notary public. The spousal consent requirement may be waived if it is established, to the satisfaction of the Administrator, that the consent may not be obtained because there is no Spouse, because the Spouse cannot be

located or because of such other circumstances as may be prescribed by applicable regulations.

## SECTION 6

## PRE-RETIREMENT DEATH BENEFIT

6.1 If a Participant dies before his Annuity Starting Date, the then value of the Participant's Individual Account shall be distributed in the form and manner provided in Section 6.3 or 6.4 hereof, whichever may be applicable. The Administrator may require such proper proof of death and such evidence of the right of any person to receive payment of the Individual Account of a deceased Participant as the Administrator may deem desirable. The Administrator's determination of death and of the right of any person to receive payment shall be final.

6.2 Each Participant shall, by written notice to the Administrator, designate a Beneficiary or Beneficiaries to receive any payment to which the Participant may be entitled under this Plan at the time of his or her death before the Annuity Starting Date, provided that a married Participant must designate his or her Spouse as Beneficiary. If a married Participant wants to designate a Beneficiary other than his or her Spouse, the Spouse of the Participant must consent in writing to such Beneficiary designation on a form provided by the Administrator, which consent shall be irrevocable. The consent shall acknowledge the financial effect of the election on the Spouse's right to death benefits under this Plan and shall be witnessed by a notary public. Both the Participant's designation and the Spouse's consent shall state the specific non-Spouse Beneficiary (including any class of Beneficiaries or any contingent Beneficiaries) who will receive the death benefit provided hereunder. The spousal consent requirement may be waived if it is established, to the satisfaction of the Administra-

tor, that the consent may not be obtained because there is no Spouse or because the Spouse cannot be located. Any Beneficiary designation made by a Participant which does not meet the requirements of this Section 6.2 and any Beneficiary designation made by an unmarried Participant who later marries shall be deemed null and void. The Participant shall have the right to change a Beneficiary designation or any subsequent Beneficiary designation, subject to the spousal consent provisions of this Section 6.2.

6.3 Except as provided in Section 6.4 hereof with respect to a surviving Spouse, the death benefit provided under this Section 6 payable to a Beneficiary, including a Participant's Spouse, shall be paid in the form of a lump sum. If the Beneficiary dies prior to receiving the death benefit, the balance shall be paid to the Beneficiary's estate in a lump sum.

6.4 In lieu of receiving a death benefit in the form of payment provided in Section 6.3 hereof, a Participant's surviving Spouse may elect to have the death benefit paid in the form of an immediate single life annuity. Such annuity shall be in the amount which can be obtained with the balance in the Participant's Individual Account at the date of the Participant's death.

## SECTION 7

## VESTING

7.1 A Participant's Accrued Benefit shall be 100% vested and nonforfeitable at all times.

## SECTION 8

## FUNDING

8.1 A Trust shall serve as the funding vehicle for the benefits provided by this Plan with respect to each Participant.

## SECTION 9

## ADMINISTRATION

9.1 The Administrator, or its designee, shall have the full power and authority to interpret and administer this Plan and the Administrator's actions in doing so shall be final and binding on all persons interested in this Plan. The Administrator shall have the same powers and authority as are set forth in the Retirement Plans. The Administrator may from time to time adopt additional or supplemental rules and regulations governing the administration of this Plan.

## SECTION 10

## AMENDMENT

10.1 The Board shall have the right to amend or modify this Plan at any time in any manner whatsoever; provided, however, that no amendment shall operate to reduce the Accrued Benefit to which any Participant who is participating in this Plan at the time the amendment is adopted would otherwise be entitled at that time.

## SECTION 11

## TERMINATION

11.1 The Board shall have the right at any time to terminate or discontinue contributions to this Plan for any reason; provided, however, that such termination or discontinuance shall not operate to reduce the Accrued Benefit to which any Participant who is participating in this Plan at the time the termination or discontinuance is adopted would otherwise be entitled at that time.

## SECTION 12

## MISCELLANEOUS

12.1 Nothing contained in this Plan shall be deemed to exclude a Participant from any compensation, bonus, pension, insurance, severance pay or other benefit to which he or she is or might otherwise become entitled as an Employee, nor shall any provision of this Plan be construed as conferring upon an Employee the right to continue in the employ of the Employer.

12.2 Any amounts payable by the Employer hereunder shall not be deemed salary or other compensation to a Participant for the purposes of computing benefits to which he or she may be entitled under any other plan or arrangement established by the Employer for the benefit of its employees, unless such plan or arrangement specifically provides to the contrary.

12.3 The rights and obligations created hereunder shall be binding on a Participant's heirs, executors and administrators and on the successors and assigns of the Employer.

12.4 Except insofar as Pennsylvania law has been pre-empted by federal law, this Plan shall be construed in accordance with and governed by the internal laws of the Commonwealth of Pennsylvania.

12.5 Except in the event of bad faith, willful misconduct or negligence, neither the Employer nor any member of the Board shall be responsible or liable in any manner to any Participant, beneficiary or any person claiming through them for any benefit or action taken or omitted in connection with the granting of benefits, the continuation of benefits, or the interpretation and administration of this Plan.

12.6 Except with respect to income tax withholding requirements and employment taxes due with respect to the contributions and other

payments made hereunder, no amount payable under this Plan shall be subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, charge or seizure; and no such amount shall be in any manner subject to the debts, contracts, liabilities, engagements or torts of any Participant or his or her Beneficiary. Notwithstanding the foregoing, the Administrator shall direct the Trustee to comply with Federal tax liens and Qualified Domestic Relations Orders. Upon receipt of any judgment, decree or order (including approval of a property settlement agreement) relating to the provision of payment by this Plan to an Alternate Payee pursuant to a state domestic relations law, the Administrator shall promptly notify the affected Participant and any Alternate Payee of the receipt of such judgment, decree or order and shall notify the affected Participant and any Alternate Payee of the Administrator's procedure for determining whether or not the judgment, decree or order is a Qualified Domestic Relations Order. The Administrator shall establish a procedure to determine the status of a judgment, decree or order as a Qualified Domestic Relations Order and to administer Plan distributions in accordance with Qualified Domestic Relations Orders. Such procedure shall be in writing, shall include a provision specifying the notification requirements enumerated above, shall permit an Alternate Payee to designate a representative for receipt of communications from the Administrator and shall include such other provisions as the Administrator shall determine, including provisions required under applicable regulations.

12.7 The named fiduciaries of this Plan shall be the Trustee, the Administrator, and any other person designated by the Administrator as a named fiduciary.

12.8 In the event of a claim by a Participant or his or her Beneficiary as to the amount of any distribution or its method of payment, such Participant or Beneficiary shall present the reason for his or her claim in writing to the Administrator. The Administrator shall, within 90 days after the receipt of such written claim, send written notification to the Participant or Beneficiary as to its disposition. In the event the claim is wholly or partially denied, such written notification shall (i) state the specific reason or reasons for the denial, (ii) make specific reference to pertinent Plan provisions on which the denial is based, (iii) provide a description of any additional material or information necessary for the Participant or Beneficiary to perfect the claim and an explanation of why such material or information is necessary and (iv) set forth the procedure by which the Participant or Beneficiary may appeal the denial of his or her claim. In the event a Participant or Beneficiary wishes to appeal the denial of his or claim, he or she may request a review of such denial by making application in writing to the Administrator within 60 days after receipt of such denial. Such Participant or Beneficiary (or his or her duly authorized representative) may, upon written request to the Administrator, review any documents pertinent to his or her claim and submit in writing issues and comments in support of his or her position. Within 60 days after receipt of the written appeal (unless an extension of time is agreed to by the parties, but in no event more than 120 days after such receipt), the Administrator shall notify the Participant or Beneficiary of its final decision. Such final decision shall be in writing and shall include specific reasons for the decision, written in a manner calculated to be understood by the

claimant, and specific references to the pertinent Plan provisions on which the decision is based.

TO RECORD the adoption of this Plan, the Employer has caused this document to be executed by its duly authorized officers on this 15th day of December, 1994.

| | |
|---|---|
| Attest: | DONEGAL MUTUAL INSURANCE COMPANY |
| /s/ Ralph G. Spontak | By:/s/ Donald H. Nikolaus |
| Secretary | Title: President |

INTEREST AND LIABILITIES CONTRACT
TO
RETROCESSIONAL REINSURANCE CONTRACT
BETWEEN
PIONEER INSURANCE COMPANY
AND
DONEGAL MUTUAL INSURANCE COMPANY

It is hereby agreed by and between Pioneer American Insurance Company (Pioneer) and Donegal Mutual Insurance Company (Donegal) that Donegal will assume and retrocede a 100% share and Pioneer will assume a 100% share of the retrocession of the Interests and Liabilities as set forth in the attached Retrocessional Reinsurance Agreement effective July 1, 1996 until terminated.

This Contract made and executed in duplicate this 21st day of May, 1996

PIONEER INSURANCE COMPANY

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

DONEGAL MUTUAL INSURANCE COMPANY

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

REINSURANCE AND RETROCESSION AGREEMENT

between

PIONEER INSURANCE COMPANY

and

DONEGAL MUTUAL INSURANCE COMPANY

Article 1 BUSINESS COVERED

This Agreement, subject to the terms and conditions herein contained, is for Donegal Mutual Insurance Company (Donegal) to indemnify Pioneer Insurance Company (Pioneer) in respect of the net liability as herein provided and specified which may accrue to Pioneer as a result of any loss or losses which may occur during the term of this Agreement under any and all binders, policies, and contracts of insurance or reinsurance (hereinafter referred to as "policy" or "policies") heretofore or hereafter issued or.entered into by or on behalf of the Pioneer and for Donegal to retrocede the net liability back to Pioneer and Pioneer to assume the net liability back from Donegal as part of the retrocession.

Article 2 Territory

This Agreement shall cover wherever the Pioneer's policies cover.

Article 3 Exclusions

This Agreement shall not cover:

A. Business classified by the Reinsured as:

(1)

Overhead transmission and distribution lines and their supporting structures other than those on or within 150 meters (or 500 feet) of the insured premises. It is understood and agreed that public utilities extension and/or suppliers extension and/or contingent business interruption coverage are not subject to this exclusion provided that these are not part of a transmitter's or distributor's policy.

(2)

Pools, Associations, or Syndicates, including State Insurance Guaranty Associations. However, such operations which Pioneer is obliged to cover by reason of membership or participation in any Automobile Assigned Risk Pool, Plan or Facility, any FAIR Plan, or any Coastal Pool are not to be excluded. Furthermore, this exclusion shall not apply to any Inter-Company Pooling.

(3) Insurance on Growing and/or Standing Crops.

(4)

Reinsurance of any kind assumed by the Reinsured, except local agency reinsurance accepted in the normal course of business.

(5)

Bridges, tunnels and art collections valued at over $150,000,000.

(6) Aviation.

(7) Insolvency Funds, as per clause attached.

(8) Flood, when written as such.

B. Extra Contractual Obligations and Loss in Excess of Original Policy Limits -- "Extra Contractual Obligations" are defined as those liabilities not covered under any other provision of this Agreement and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to, the following: failure by Pioneer to settle within the policy limit, or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its Insured or Reinsured or in the preparation or prosecution of an appeal consequent upon such action.

The term "Loss in Excess of Original Policy Limits" shall mean a net loss of Pioneer which is in excess of the limit of its original policy, such loss in excess of the limit having been incurred because of the following: failure by Pioneer to settle within the policy limit or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer or settlement or in the preparation of the defense or in the trial of any action against its Insured or Reinsured or in the preparation or prosecution of an appeal consequent upon such action.

C. Fidelity, Surety, Credit, Title, Insolvency and Financial Guaranty.

D. Loss or Liability excluded by the provisions of the Nuclear Incident Exclusion Clause - Physical Damage - Reinsurance, as per clause attached hereto.

E. War, as defined in the original policy.

F. Ocean Marine

Article 4 Term

This Agreement shall become effective on July 1, 1996 at 12:01 A.M. Standard Time. It is unlimited as to its duration and may be terminated by either party upon giving ninety (90) days notice of cancellation in writing. In the event either party terminates in accordance with the above, it is understood that all transactions coming within the terms of this Agreement will continue in effect within the said ninety (90) days.

Article 5 DEFINITION OF LOSS OCCURRENCE

The term "Loss Occurrence" shall mean any one occurrence or series of occurrences arising out of one event.

Article 6 NET RETAINED LINES

This Agreement applies only to that portion of any insurance or reinsurance covered by this Agreement which Pioneer retains net for its own account, and in calculating the amount of any loss hereunder and also in computing the amount in excess of which this Agreement attaches, only loss or losses in respect of that portion of any insurance or reinsurance which Pioneer retains net for its own account shall be included. It being understood and agreed that the amount of Donegal's liability hereunder in respect of any loss or losses shall not be increased by reason of the inability of the Pioneer to collect from any other reinsurer, whether specific or general any amounts which may have become due from them whether such inability arises from the insolvency of such other reinsurer or otherwise.

Article 7 ULTIMATE NET LOSS INCURRED

The term "Ultimates Net Loss Incurred" shall be understood to mean the actual loss or losses incurred or to be incurred by Pioneer under its policies, such loss or losses to include expenses of litigation, if any, interest accrued where such interest is part of the judgment and all other loss expenses of Pioneer including legal expenses and costs incurred in connection with coverage and validity questions and legal actions connected thereto which are allocable only to a specific claim or action on policies covered hereunder less proper deductions for all recoveries (including amounts recoverable under other reinsurance) and salvages actually made by the Pioneer; provided always that nothing in this Article shall be construed to mean that losses under this Agreement are not recoverable until Pioneer's ultimate net loss has been ascertained.

All salvages, recoveries and payments recovered or received subsequent to a loss settlement under this Agreement shall be applied as if recovered or received prior to the said settlement and all necessary adjustments shall be made by the parties hereto.

Article 8 CEDING AND RETROCEDING NET LOSS

(a) As of the effective date and time of this agreement Pioneer will cede and Donegal will accept 100% of Pioneer's Net Liability for losses. Thereafter Pioneer will cede and Donegal will accept 100% of Pioneer's Net Losses Incurred, including allocated loss adjusting expense incurred. (b) As of the effective date and time of this agreement Donegal will retrocede and Pioneer will accept 100% of the net liability for losses Donegal assumed from Pioneer and, thereafter, Donegal will retrocede 100% of the Net Incurred Losses it assumed from Pioneer including allocated loss adjusting expenses incurred.

Article 9 RATE AND PREMIUM

Pioneer shall pay to Donegal and Donegal will retrocede to Pioneer during the term of this Agreement Net Earned Premium Income of Pioneer during such term in respect of business the subject matter of this Agreement.

The term "Net Earned Premium Income" as used herein shall be understood to mean gross premiums earned by Pioneer less premiums for reinsurance which inure to the benefit of this Agreement.

All premiums and losses paid under this Agreement shall be made in United States currency.

Article 10 ACCESS TO RECORDS

Pioneer and Donegal, by their duly appointed representatives, shall have the right at any reasonable time, to examine all papers in the possession of the other referring to business effected hereunder.

Article 11 ERRORS AND OMISSIONS

Any inadvertent delay, omission or error shall not be held to relieve either party hereto from any liability which would attach to it hereunder if such delay, omission or error had not been made. Such delay, omission or error shall be rectified immediately upon discovery.

Article 12

As a precedent to any right of action hereunder, if any dispute shall arise between Pioneer and Donegal with reference to the interpretation of this Agreement or their rights with respect to any transaction involved, whether such dispute arises before or after termination of this Agreement, such dispute upon the written request of either party, shall be submitted to three

arbitrators, one to be chosen by each party, and the third by the two so chosen. If either party refuses or neglects to appoint an arbitrator within thirty days after the receipt of written notice from the other party requesting it to do so, the requesting party may appoint two arbitrators. If the two arbitrators fail to agree in the selection of a third arbitrator within thirty days of their appointment, each of them shall name two, of whom the other shall decline one and the decision shall be made by drawing lots. All arbitrators shall be disinterested active or retired executive officers of insurance or reinsurance companies or Underwriters at Lloyd's, London not under the control of either party to this Agreement.

The Arbitrators shall interpret the Agreement and make their decision with regard to the custom and usage of the insurance and reinsurance business. They shall issue their decision in writing based upon a hearing in which evidence may be introduced without following strict rules of evidence, but in which cross examination and rebuttal shall be allowed. They shall make their award with a view to effecting the general purpose of this Agreement in a reasonable manner rather than in accordance with a literal interpretation of the language.

The decision in writing of any two arbitrators, when filed with the parties hereto, shall be final and binding on both parties. Judgment may be entered upon the final decision of the arbitrators in any court having jurisdiction. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the expense of the third arbitrator and of the arbitration. Said arbitration shall take place in Marietta, Pennsylvania unless some other place is mutually agreed upon by Pioneer and Donegal.

## Article 13 INSOLVENCY FUNDS EXCLUSION CLAUSE

This Agreement excludes all liability of Pioneer arising, by contract, operation of law, or otherwise, from its participation or membership, whether voluntary or involuntary, in any insolvency fund. "Insolvency fund" includes any guaranty fund, insolvency fund, plan, pool, association, fund or other arrangement, howsoever denominated, established or governed; which provides for any assessment of or payment or assumption by the Company of part or all of any claim, debt, charge, fee, or other obligation of an insurer, or its successors or assigns, which has been declared by any competent authority to be insolvent, or which is otherwise deemed unable to meet any claim, debt, charge, fee or other obligation in whole or in part.

INTEREST AND LIABILITIES CONTRACT
TO
RETROCESSIONAL REINSURANCE CONTRACT
BETWEEN
DELAWARE AMERICAN INSURANCE COMPANY
AND
DONEGAL MUTUAL INSURANCE COMPANY

It is hereby agreed by and between Delaware American Insurance Company (Delaware) and Donegal Mutual Insurance Company (Donegal) that Donegal will assume and retrocede a 100% share and Delaware will assume a 100% share of the retrocession of the Interests and Liabilities as set forth in the attached Retrocessional Reinsurance Agreement effective July 1, 1996 until terminated.

This Contract made and executed in duplicate this 21st day of May, 1996

DELAWARE AMERICAN INSURANCE COMPANY

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

DONEGAL MUTUAL INSURANCE COMPANY

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

REINSURANCE AND RETROCESSION AGREEMENT

between

DELAWARE AMERICAN INSURANCE COMPANY
and

DONEGAL MUTUAL INSURANCE COMPANY

Article 1 BUSINESS COVERED

This Agreement, subject to the terms and conditions herein contained, is for Donegal Mutual Insurance Company (Donegal) to indemnify Delaware American Insurance Company (Delaware) in respect of the net liability as herein provided and specified which may accrue to Delaware as a result of any loss or losses which may occur during the term of this Agreement under any and all binders, policies, and contracts of insurance or reinsurance (hereinafter referred to as "policy" or "policies") heretofore or hereafter issued or entered into by or on behalf of the Delaware and for Donegal to retrocede the net liability back to Delaware and Delaware to assume the net liability back from Donegal as part of the retrocession.

Article 2 Territory

This Agreement shall cover wherever the Delaware's policies cover.

Article 3 Exclusions

This Agreement shall not cover:

A. Business classified by the Reinsured as:

(1)

Overhead transmission and distribution lines and their supporting structures other than those on or within 150 meters (or 500 feet) of the insured premises. It is understood and agreed that public utilities extension and/or suppliers extension and/or contingent business interruption coverage are not subject to this exclusion provided that these are not part of a transmitter's or distributor's policy.

{2)

Pools, Associations, or Syndicates, including State Insurance Guaranty Associations. However, such operations which Delaware is obliged to cover by reason of membership or participation in any Automobile Assigned Risk Pool, Plan or Facility, any FAIR Plan, or any Coastal Pool are not to be excluded. Furthermore, this exclusion shall not apply to any Inter-Company Pooling.

(3) Insurance on Growing and/or Standing Crops.

(4)
Reinsurance of any kind assumed by the Reinsured, except local agency reinsurance accepted in the normal course of business.

(5) Bridges, tunnels and art collections valued at over $150,000,000.

(6) Aviation.

(7) Insolvency Funds, as per clause attached.

(8) Flood, when written as such.

B. Extra Contractual Obligations and Loss in Excess of Original Policy Limits -- "Extra Contractual Obligations" are defined as those liabilities not covered under any other provision of this Agreement and which arise from the handling of any claim on business covered hereunder, such liabilities arising because of, but not limited to, the following: failure by Delaware to settle within the policy limit, or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in the preparation of the defense or in the trial of any action against its Insured or Reinsured or in the preparation or prosecution of an appeal consequent upon such action.

The term "Loss in Excess of Original Policy Limits" shall mean a net loss of Delaware which is in excess of the limit of its original policy, such loss in excess of the limit having been incurred because of the following: failure by Delaware to settle within the policy limit or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer or settlement or in the preparation of the defense or in the trial of any action against its Insured or Reinsured or in the preparation or prosecution of an appea1 consequent upon such action.

C. Fidelity, Surety, Credit, Title, Insolvency and Financial Guaranty.

D. Loss or Liability excluded by the provisions of the Nuclear Incident Exclusion Clause - Physical Damage - Reinsurance, as per clause attached hereto.

E. War, as defined in the original policy.

F. Ocean Marine

Article 4 Term

This Agreement shall become effective on July 1, 1996 at 12:01 A. M. Standard Time. It is unlimited as to its duration and may be terminated by either party upon giving ninety (90) days notice of cancellation in writing. In the event either party terminates in accordance with the above, it is understood that all transactions coming within the terms of this Agreement will continue in effect within the said ninety (90) days.

Article 5 DEFINITION OF LOSS OCCURRENCE

The term "Loss Occurrence" shall mean any one occurrence or series of occurrences arising out of one event.

ARTICLE 6 NET RETAINED LINES

This Agreement applies only to that portion of any insurance or reinsurance covered by this Agreement which Delaware retains net for its own account, and in calculating the amount of any loss hereunder and also in computing the amount in excess of which this Agreement attaches, only loss or losses in respect of that portion of any insurance or reinsurance which Delaware retains net for its own account shall be included. It being understood and agreed that the amount of Donegal's liability hereunder in respect of any loss or losses shall not be increased by reason of the inability of the Delaware to collect from any other reinsurer, whether specific or general any amounts which may have become due from them whether such inability arises from the insolvency of such other reinsurer or otherwise.

Article 7 ULTIMATE NET LOSS INCURRED

The term "Ultimate Net Loss Incurred" shall be understood to mean the actual loss or losses incurred or to be incurred by Delaware under its policies, such loss or losses to include expenses of litigation, if any, interest accrued where such interest is part of the judgment and all other loss expenses of Delaware including legal expenses and costs incurred in connection with coverage and validity questions and legal actions connected thereto which are allocable only to a specific claim or action on policies covered hereunder less proper deductions for all recoveries (including amounts recoverable under other reinsurance) and salvages actually made by the Delaware; provided always that nothing in this Article shall be construed to mean that losses under this Agreement are not recoverable until Delaware's ultimate net loss has been ascertained.

All salvages, recoveries and payments recovered or received subsequent to a loss settlement under this Agreement shall be applied as if recovered or received prior to the said settlement and all necessary adjustments shall be made by the parties hereto.

ARTICLE 8 CEDING AND RETROCEDING NET LOSS

(a) As of the effective date and time of this agreement Delaware will cede and Donegal will accept 100% of Delaware's Net Liability for losses. Thereafter Delaware will cede and Donegal will accept 100% of Delaware's Net Losses Incurred, including allocated loss adjusting expense incurred.

(b) As of the effective date and time of this agreement Donegal will retrocede and Delaware will accept 100% of the net liability for losses Donegal assumed from Delaware and, thereafter, Donegal will retrocede 100% of the Net Incurred Losses it assumed from Delaware including allocated loss adjusting expenses incurred.

ARTICLE 9 RATE AND PREMIUM

Delaware shall pay to Donegal and Donegal will retrocede to Delaware during the term of this Agreement Net Earned Premium Income of Delaware during such term in respect of business the subject matter of this Agreement.

The term "Net Earned Premium Income" as used herein shall be understood to mean gross premiums earned by Delaware less premiums for reinsurance which inure to the benefit of this Agreement.

All premiums and losses paid under this Agreement shall be made in United States currency.

ARTICLE 10 ACCESS TO RECORDS

Delaware and Donegal, by their duly appointed representatives, shall have the right at any reasonable time, to examine all papers in the possession of the other referring to business effected hereunder.

ARTICLE 11 ERRORS AND OMISSIONS

Any inadvertent delay, omission or error shall not be held to relieve either party hereto from any liability which would attach to it hereunder if such delay, omission or error had not been made. Such delay, omission or error shall be rectified immediately upon discovery.

ARTICLE 12

As a precedent to any right of action hereunder, if any dispute shall arise between Delaware and Donegal with reference to the interpretation of this Agreement or their rights with respect to any transaction involved, whether such dispute arises before or after termination of this Agreement, such dispute upon the written request of either party, shall be submitted to three

arbitrators, one to be chosen by each party, and the third by the two so chosen. If either party refuses or neglects to appoint an arbitrator within thirty days after the receipt of written notice from the other party requesting it to do so, the requesting party may appoint two arbitrators. If the two arbitrators fail to agree in the selection of a third arbitrator within thirty days of their appointment, each of them shall name two, of whom the other shall decline one and the decision shall be made by drawing lots. All arbitrators shall be disinterested active or retired executive officers of insurance or reinsurance companies or Underwriters at Lloyd's, London not under the control of either party to this Agreement.

The Arbitrators shall interpret the Agreement and make their decision with regard to the custom and usage of the insurance and reinsurance business. They shall issue their decision in writing based upon a hearing in which evidence may be introduced without following strict rules of evidence, but in which cross examination and rebuttal shall be allowed. They shall make their award with a view to effecting the general purpose of this Agreement in a reasonable manner rather than in accordance with a literal interpretation of the language.

The decision in writing of any two arbitrators, when filed with the parties hereto, shall be final and binding on both parties. Judgment may be entered upon the final decision of the arbitrators in any court having jurisdiction. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the expense of the third arbitrator and of the arbitration. Said arbitration shall take place in Marietta, Pennsylvania unless some other place is mutually agreed upon by Delaware and Donegal.

ARTICLE 13 INSOLVENCY FUNDS EXCLUSION CLAUSE

This Agreement excludes all liability of Delaware arising, by contract, operation of law, or otherwise, from its participation or membership, whether voluntary or involuntary, in any insolvency fund. "Insolvency fund" includes any guaranty fund, insolvency fund, plan, pool, association, fund or other arrangement, howsoever denominated, established or governed; which provides for any assessment of or payment or assumption by the Company of part or all of any claim, debt, charge, fee, or other obligation of an insurer, or its successors or assigns, which has been declared by any competent authority to be insolvent, or which is otherwise deemed unable to meet any claim, debt, charge, fee or other obligation in whole or in part.

INTEREST AND LIABILITIES CONTRACT

TO

RETROCESSIONAL REINSURANCE CONTRACT

BETWEEN

SOUTHERN INSURANCE COMPANY OF VIRGINIA

AND

DONEGAL MUTUAL INSURANCE COMPANY

It is hereby agreed by and between Southern Insurance Company of Virginia (Southern) and Donegal Mutual Insurance Company (Donegal) that Donegal will assume and retrocede a 100% share and Southern will assume a 100% share of the retrocession of the Interests and Liabilities as set forth in the attached Retrocessional Reinsurance Agreement effective July 1, 1996 until terminated.

This Contract made and executed in duplicate this 21st day of May, 1996

SOUTHERN INSURANCE COMPANY OF VIRGINIA

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

DONEGAL MUTUAL INSURANCE COMPANY

/s/ RALPH G. SPONTAK
- ----------
RALPH G. SPONTAK, SECRETARY

REINSURANCE AND RETROCESSION AGREEMENT

between

SOUTHERN INSURANCE COMPANY OF VIRGINIA

and

DONEGAL MUTUAL INSURANCE COMPANY

Article 1 BUSINESS COVERED

This Agreement, subject to the terms and conditions herein contained, is for Donegal Mutual Insurance Company (Donegal) to indemnify Southern Insurance Company of Virginia (Southern) in respect of the net liability as herein provided and specified which may accrue to Southern as a result of any loss or losses which may occur during the term of this Agreement under any and all binders, policies, and contracts of insurance or reinsurance (hereinafter referred to as "policy" or "policies) heretofore or hereafter issued or entered into by or on behalf of the Southern and for Donegal to retrocede the net liability back to Southern and Southern to assume the net liability back from Donegal as part of the retrocession.

Article 2 Territory

This Agreement shall cover wherever the Southern's policies cover.

Article 3 Exclusions

This Agreement shall not cover:

A. Business classified by the Reinsured as:

(1)

Overhead transmission and distribution lines and their supporting structures other than those on or within 150 meters (or 500 feet) of the insured premises. It is understood and agreed that public utilities extension and/or suppliers extension and/or contingent business interruption coverage are not subject to this exclusion provided that these are not part of a transmitter's or distributor's policy.

(2)

Pools, Associations, or Syndicates, including State Insurance Guaranty Associations. However, such operations which Southern is obliged to cover by reason of membership or participation in any Automobile Assigned Risk Pool, Plan or Facility, any FAIR Plan, or any Coastal Pool are not to be excluded. Furthermore, this exclusion shall not apply to any Inter-Company Pooling.

(3) Insurance on Growing and/or Standing Crops.

(4)

Reinsurance of any kind assumed by the Reinsured, except local agency reinsurance accepted in the normal course of business.

(5) Bridges, tunnels and art collections valued at over $150,000,000.

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The term "Loss in Excess of Original Policy Limits" shall mean a net loss of Southern which is in excess of the limit of its original policy, such loss in excess of the limit having been incurred because of the following: failure by Southern to settle within the policy limit or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer or settlement or in the preparation of the defense or in the trial of any action against its Insured or Reinsured or in the preparation or prosecution of an appeal consequent upon such action.

C. Fidelity, Surety, Credit, Title, Insolvency and Financial Guaranty.

D. Loss or Liability excluded by the provisions of the Nuclear Incident Exclusion Clause - Physical Damage - Reinsurance, as per clause attached hereto.

E.  War, as defined in the original policy.

F.  Ocean Marine

Article 4  Term

This Agreement shall become effective on July 1, 1996 at 12:01 A. M. Standard Time. It is unlimited as to its duration and may be terminated by either party upon giving ninety (90) days notice of cancellation in writing. In the event either party terminates in accordance with the above, it is understood that all transactions coming within the terms of this Agreement will continue in effect within the said ninety (90) days.

Article 5  DEFINITION OF LOSS OCCURRENCE

The term "Loss Occurrence" shall mean any one occurrence or series of occurrences arising out of one event.

ARTICLE 6  NET RETAINED LINES

This Agreement applies only to that portion of any insurance or reinsurance covered by this Agreement which Southern retains net for its own account, and in calculating the amount of any loss hereunder and also in computing the amount in excess of which this Agreement attaches, only loss or losses in respect of that portion of any insurance or reinsurance which Southern retains net for its own account shall be included. It being understood and agreed that the amount of Donegal's liability hereunder in respect of any loss or losses shall not be increased by reason of the inability of the Southern to collect from any other reinsurer, whether specific or general any amounts which may have become due from them whether such inability arises from the insolvency of such other reinsurer or otherwise.

Article 7  ULTIMATE NET LOSS INCURRED

The term "Ultimate Net Loss Incurred" shall be understood to mean the actual loss or losses incurred or to be incurred by Southern under its policies, such loss or losses to include expenses of litigation, if any, interest accrued where such interest is part of the judgment and all other loss expenses of Southern including legal expenses and costs incurred in connection with coverage and validity questions and legal actions connected thereto which are allocable only to a specific claim or action on policies covered hereunder less proper deductions for all recoveries (including amounts recoverable under other reinsurance) and salvages actually made by the Southern; provided always that nothing in this Article shall be construed to mean that losses under this Agreement are not recoverable until Southern's ultimate net loss has been ascertained.

All salvages, recoveries and payments recovered or received subsequent to a loss settlement under this Agreement shall be applied as if recovered or received prior to the said settlement and all necessary adjustments shall be made by the parties hereto.

ARTICLE 8 CEDING AND RETROCEDING NET LOSS

(a) As of the effective date and time of this agreement Southern will cede and Donegal will accept 100% of Southern's Net Liability for losses. Thereafter Southern will cede and Donegal will accept 100% of Southern's Net Losses Incurred, including allocated loss adjusting expense incurred.

(b) As of the effective date and time of this agreement Donegal will retrocede and Southern will accept 100% of the net liability for losses Donegal assumed from Southern and, thereafter, Donegal will retrocede 100% of the Net Incurred Losses it assumed from Southern including allocated loss adjusting expenses incurred.

ARTICLE 9 RATE AND PREMIUM

Southern shall pay to Donegal and Donegal will retrocede to Southern during the term of this Agreement Net Earned Premium Income of Southern during such term in respect of business the subject matter of this Agreement.

The term "Net Earned Premium Income" as used herein shall be understood to mean gross premiums earned by Southern less premiums for reinsurance which inure to the benefit of this Agreement.

All premiums and losses paid under this Agreement shall be made in United States currency.

ARTICLE 10 ACCESS TO RECORDS

Southern and Donegal, by their duly appointed representatives, shall have the right at any reasonable time, to examine all papers in the possession of the other referring to business effected hereunder.

ARTICLE 11 ERRORS AND OMISSIONS

Any inadvertent delay, omission or error shall not be held to relieve either party hereto from any liability which would attach to it hereunder if such delay, omission or error had not been made. Such delay, omission or error shall be rectified immediately upon discovery.

ARTICLE 12

As a precedent to any right of action hereunder, if any dispute shall arise between Southern and Donegal with reference to the interpretation of this Agreement or their rights with respect to any transaction involved, whether such dispute arises before or after termination of this Agreement, such dispute upon the written request of either party, shall be submitted to three

arbitrators, one to be chosen by each party, and the third by the two so chosen. If either party refuses or neglects to appoint an arbitrator within thirty days after the receipt of written notice from the other party requesting it to do so, the requesting party may appoint two arbitrators. If the two arbitrators fail to agree in the selection of a third arbitrator within thirty days of their appointment, each of them shall name two, of whom the other shall decline one and the decision shall be made by drawing lots. All arbitrators shall be disinterested active or retired executive officers of insurance or reinsurance companies or Underwriters at Lloyd's, London not under the control of either party to this Agreement.

The Arbitrators shall interpret the Agreement and make their decision with regard to the custom and usage of the insurance and reinsurance business. They shall issue their decision in writing based upon a hearing in which evidence may be introduced without following strict rules of evidence, but in which cross examination and rebuttal shall be allowed. They shall make their award with a view to effecting the general purpose of this Agreement in a reasonable manner rather than in accordance with a literal interpretation of the language.

The decision in writing of any two arbitrators, when filed with the parties hereto, shall be final and binding on both parties. Judgment may be entered upon the final decision of the arbitrators in any court having jurisdiction. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the expense of the third arbitrator and of the arbitration. Said arbitration shall take place in Marietta, Pennsylvania unless some other place is mutually agreed upon by Southern and Donegal.

## ARTICLE 13 INSOLVENCY FUNDS EXCLUSION CLAUSE

This Agreement excludes all liability of Southern arising, by contract, operation of law, or otherwise, from its participation or membership, whether voluntary or involuntary, in any insolvency fund. "Insolvency fund" includes any guaranty fund, insolvency fund, plan, pool, association, fund or other arrangement, howsoever denominated, established or governed; which provides for any assessment of or payment or assumption by the Company of part or all of any claim, debt, charge, fee, or other obligation of an insurer, or its successors or assigns, which has been declared by any competent authority to be insolvent, or which is otherwise deemed unable to meet any claim, debt, charge, fee or other obligation in whole or in part.

ITEM 5.

Board of Directors and Officers

Donegal Group Inc.

Board of Directors

Donald H. Nikolaus
President, Chief Executive
Officer and a Director

C. Edwin Ireland
Chairman of the Board
and a Director

Philip H. Glatfelter, II
Vice Chairman of the Board
and a Director

Robert S. Bolinger
Director

Thomas J. Finley, Jr.
Director

Patricia A. Gilmartin
Director

R. Richard Sherbahn
Director

Officers

C. Edwin Ireland
Chairman of the Board

Philip H. Glatfelter, II
Vice Chairman of the Board

Donald H. Nikolaus
President and Chief
Executive Officer

Ralph G. Spontak
Senior Vice President,
Chief Financial Officer
and Secretary

Daniel J. Wagner
Treasurer

Donegal Mutual

Board of Directors

Donald H. Nikolaus
President, Chief Executive
Officer and a Director

C. Edwin Ireland
Chairman of the Board
and a Director

Philip H. Glatfelter, II
Vice Chairman of the Board
and a Director

Frederick W. Dreher
Director

Patricia A. Gilmartin
Director

Charles A. Heisterkamp, III
Director

John E. Hiestand
Director

R. Richard Sherbahn
Director

William H. Shupert
Senior Vice President
of Underwriting and a Director

Ralph G. Spontak
Senior Vice President,
Chief Financial Officer,
Secretary and a Director

Other Officers

Daniel J. Wagner
Treasurer

Cyril J. Greenya
Vice President of Commercial
Underwriting

James B. Price
Vice President of Claims

Robert G. Shenk
Vice President of Claims

Frank J. Wood
Vice President of Marketing

Corporate Information

Annual Meeting
April 17, 1997 at the Company's headquarters at 10:00 a.m.

Form 10-K
A copy of Donegal Group's Annual Report on Form 10-K, will be furnished free upon written request to Ralph G. Spontak, Senior Vice President and Chief Financial Officer, at the address listed below.

Market Information
Donegal Group's common stock is traded on NASDAQ under the symbol "DGIC." During 1995 and 1996, the stock price ranged as follows:

| Quarter | High | Low | Cash Dividend Declared Per Share |
|---|---|---|---|
| 1995 | | | |
| 1st | 15 | 13-15/16 | -- |
| 2nd | 17-1/2 | 14 | .10 |
| 3rd | 17-3/4 | 16 | .10 |
| 4th | 19-1/4 | 17 | .20 |
| 1996 | | | |
| 1st | 19-1/2 | 18-1/2 | -- |
| 2nd | 19 | 16-3/4 | .11 |
| 3rd | 18-3/4 | 16-1/4 | .11 |
| 4th | 20-3/4 | 17-1/2 | .22 |

Corporate Offices
1195 River Road
Box 302
Marietta, Pennsylvania 17547
(717) 426-1931

Transfer Agent
First Chicago Trust Company of New York
Mail Suite 4693
P.O. Box 2535
Jersey City, NJ 07303-2535
(201) 324-0313

Stockholders
The number of common stockholders of record as of December 31, 1996 was 363.

ITEM 6.

[Graphic]

The printed document has four bar graphs, side by side and contain plot points as indicated below:

| | Total Assets in dollars | Book Value Per Share dollars | Invested Assets in dollars | Total Revenue in dollars |
|---|---|---|---|---|
| 1992 | 131,135,002 | 12.18 | 94,723,299 | 62,107,673 |
| 1993 | 169,460,466 | 14.03 | 122,221,131 | 77,698,608 |
| 1994 | 207,721,362 | 14.78 | 147,050,375 | 86,354,530 |
| 1995 | 235,704,366 | 16.96 | 163,135,881 | 97,885,060 |
| 1996 | 273,128,543 | 18.18 | 188,423,528 | 112,519,031 |

Financial Highlights

| Year Ended December 31, | 1996 | 1995 | 1994 | 1993 | 1992 |
|---|---|---|---|---|---|
| Income Statement Data | | | | | |
| Net premiums earned | $ 99,982,042 | $ 86,277,852 | $ 77,232,889 | $ 69,415,874 | $ 54,630,786 |

| | | | | | |
|---|---|---|---|---|---|
| Investment income | 10,316,468 | 9,269,884 | 7,778,164 | 6,478,354 | 6,042,163 |
| Total revenues | 112,519,031 | 97,885,060 | 86,354,530 | 77,698,608 | 62,107,673 |
| Net income | 8,896,113 | 9,857,950 | 5,039,948 | 6,382,449 | 4,948,744 |
| Net income per common share | 2.01 | 2.31 | 1.20 | 1.92 | 1.65 |

Balance Sheet Data

| | | | | | |
|---|---|---|---|---|---|
| Total assets | $273,128,543 | $235,704,366 | $207,721,362 | $169,460,466 | $131,135,002 |
| Stockholders' equity | 81,277,371 | 72,282,892 | 60,565,067 | 57,345,586 | 36,417,485 |
| Book value per share | 18.18 | 16.96 | 14.78 | 14.03 | 12.18 |

ITEM 7.

Management's Discussion and Analysis of Results of Operation
and Financial Condition

Donegal Group Inc. ("DGI" or the "Company") is a regional insurance holding company doing business in Pennsylvania, Maryland, Delaware, Virginia and Ohio through its three wholly owned property-casualty insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern") and Delaware Atlantic Insurance Company ("Delaware") which changed its name from Delaware American Insurance Company effective August 29, 1996 (collectively "Insurance Subsidiaries"). The Company's major lines of business in 1996 and their percentage of total net earned premiums were Automobile Liability (27.7%), Workers' Compensation (18.0%), Automobile Physical Damage (16.0%), Homeowners (16.6%), and Commercial Multiple Peril (16.0%). The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. DGI was formed in September 1986 by Donegal Mutual Insurance Company (the "Mutual Company"), which owns 59% of the outstanding common shares of the Company as of December 31, 1996.

Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 65% (60% in 1995 and 1994) of the pooled business. Southern cedes 50% of its business to the Mutual Company and Delaware cedes 70% of its Workers' Compensation business to the Mutual Company. Because the Mutual Company places substantially all of the business assumed from Southern and Delaware into the pool, from which the Company has a 65% allocation, the Company's results of operations include approximately 80% of the business written by Southern and approximately 70% of the Workers' Compensation business written by Delaware.

In addition to the Company's insurance subsidiaries, it also owns all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), which was formed and began business in January 1994. AIS is an insurance services organization currently providing inspection and policy auditing information on a fee for service basis to its affiliates and the insurance industry.

Results of Operation 1996 Compared to 1995

Total revenues for 1996 were $112,519,031 which were $14,633,971, or 15.0% greater than 1995. Net premiums earned increased to $99,982,042, an increase of $13,704,190, or 15.9% over 1995. An increase in Atlantic States' share of the pool with the Mutual Company, from 60% to 65% effective January 1, 1996 accounted for $6,701,309, or 7.8% of this increase. A 1.9% increase in the direct premiums written by the combined pool of Atlantic States and the Mutual Company, a 15.8% increase in the direct premiums written of Southern and a 6.3% increase in the direct premiums written of Delaware accounted for a majority of the remaining increase. The Company posted a realized gain of $172,734 compared to a realized gain of $398,587 in 1995. Both gains resulted from normal turnover of the Company's investment portfolio. As of December 31, 1996, 99.9% of the Company's bond portfolio was classified as Class I (highest quality) by the National Association of Insurance Commissioners' Security Valuation Office. Investment income increased $1,046,584. An increase in the average invested assets from $153,477,866 to $174,905,542, offset by a decrease in the average yield to 5.9% from 6.0% in 1995, accounted for the change.

The GAAP combined ratio of insurance operations was 99.4% in 1996, compared to 97.3% in 1995. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjustment expense to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 1996 was 66.6%, compared to 64.2% in 1995 accounting for the change. This increase in the loss ratio resulted from increased claim activity due to severe winter weather in the primary operating areas of the Company in the first quarter 1996. The loss ratio in the first quarter

was 72.1% compared to 64.8% for the rest of the year. The expense ratio for 1996 was 31.2% compared to 31.8% in 1995 with the dividend ratio increasing from 1.3% in 1995 to 1.5% in 1996 due to improved loss ratios in workers' compensation in 1996.

Results of Operation 1995 Compared to 1994

Total revenues for 1995 were $97,885,060 which were $11,530,530, or 13.4% greater than 1994. Net premiums earned increased to $86,277,852, an increase of $9,044,963, or 11.7% over 1994. A 12.0% increase in the direct premiums written by the combined pool of Atlantic States and the Mutual Company, a 15.1% increase in the direct premiums written of Southern and a 67.4% increase in the direct premiums written of Delaware accounted for most of the increase. Premiums earned in 1994 were offset by additional reinsurance premiums of approximately $1 million which resulted from the reinstatement of catastrophic reinsurance contracts which were impacted by severe weather which hit the northeast part of the United States during the first quarter of that year. The increase in the direct premiums written by the combined pool was distributed among a number of the major lines, with Commercial Multiple Peril representing the largest increase for any individual line, with a 28% increase over 1994. The Company posted a realized gain of $398,587, compared to a realized gain of $34,333 in 1994. Both gains resulted from normal turnover of the Company's investment portfolio. As of December 31, 1995, all of the Company's bond portfolio was classified as Class I (highest quality) by the National Association of Insurance Commissioners' Security Valuation Office. Investment income increased $1,491,720. An increase in the average invested assets from $137,514,214 to $153,477,866, and an increase in the average yield to 6.0% from 5.7% in 1994, accounted for the increase.

The GAAP combined ratio of insurance operations was 97.3% in 1995, compared to 101.7% in 1994. The GAAP combined ratio is the sum of the ratios of incurred losses and loss adjustment expense to premiums earned (loss ratio), underwriting expenses to premiums earned (expense ratio) and policyholder dividends to premiums earned (dividend ratio). The loss ratio in 1995 was 64.2% compared to 68.4% in 1994. The total effect of the first quarter storms in 1994 was an increase in the loss for that year of 2.6%, which would have resulted in a loss ratio of 65.8% for 1994 net of this effect. The expense ratio for 1995 was 31.8%, compared to 31.5% in 1994 with the dividend ratio going from 1.7% in 1994 to 1.3% in 1995, due to more stringent qualification requirements to earn a dividend in 1995.

Liquidity and Capital Resources

The Company generates sufficient funds from its operations and maintains a high degree of liquidity in its investment portfolio. The primary source of funds to meet the demands of claim settlements and operating expenses are premium collections, investment earnings and maturing investments. As of December 31, 1996, the Company had no material commitment for capital expenditures.

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

As of December 31, 1996, pursuant to a credit agreement dated December 29, 1995, with Fleet National Bank of Connecticut, the Company had unsecured borrowings of $8.5 million. Such borrowings were made in connection with the acquisition of Delaware and a $5 million capital contribution to Atlantic States. Per the terms of the credit agreement, the Company may borrow up to $20 million at interest rates equal to the bank's then current prime rate or the then current London

interbank Eurodollar bank rate plus 1.70%. At December 31, 1996, the interest rate on the outstanding balance was 7.325%. In addition, the Company will pay a non-use fee at a rate of 3/10 of 1% per annum on the average daily unused portion of the Bank's commitment. On each December 29, commencing December 29, 1998, the credit line will be reduced by $4 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

The Company's principal sources of cash with which to meet obligations and pay stockholder dividends are dividends from the Insurance Subsidiaries which are required by law to maintain certain minimum surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. The Insurance Subsidiaries are also subject to Risk Based Capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 1996, all three Companies' statutory capital and surplus were substantially above the RBC requirements. At December 31, 1996, amounts available for distribution as dividends to Donegal Group without prior approval of the insurance regulatory authorities are $5,410,536 from Atlantic States, $255,480 from Southern and $1,120,952 from Delaware.

Net unrealized gains resulting from fluctuations in the fair value of investments reported in the balance sheet at fair value were $420,998 (net of applicable federal income tax) at December 31, 1996, and $819,213 (net of applicable federal income tax) at December 31, 1995.

## Credit Risk

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

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

## Impact of Inflation

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

## Impact of New Accounting Standards

### Stock-Based Compensation

Stock-based compensation plans are accounted for under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. As such, compensation expense would be recorded on the date of a stock option grant only if the current market price of the underlying stock exceeded the exercise price. Statement of Financial Accounting Standards (SFAS)No. 123, "Accounting for Stock-based Compensation" is effective for 1996 and permits entities to recognize as expense, over the vesting period, the fair value of all stock-based awards on the date of the grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosures under SFAS No. 123.

ITEM 8.

Donegal Group Inc.
Consolidated Balance Sheets

| December 31, | 1996 | 1995 |
|---|---|---|
| **Assets** | | |
| **Investments** | | |
| Fixed maturities | | |
| Held to maturity, at amortized cost (fair value $113,461,217 and $95,357,840) | $111,581,162 | $ 91,979,122 |
| Available for sale, at fair value (amortized cost $49,314,520 and $50,714,887) | 49,588,543 | 51,646,730 |
| Equity securities, available for sale, at fair value (cost $2,770,346 and $2,954,487) | 3,134,198 | 3,263,878 |
| Short-term investments, at cost, which approximates fair value | 21,207,503 | 14,498,579 |
| Total investments | 185,511,406 | 161,388,309 |
| Cash | 2,912,122 | 1,747,572 |
| Accrued investment income | 2,534,048 | 2,414,095 |
| Premiums receivable | 10,133,338 | 11,790,396 |
| Reinsurance receivable | 37,474,966 | 28,179,699 |
| Deferred policy acquisition costs | 7,837,899 | 6,902,218 |
| Federal income taxes receivable | -- | 551,990 |
| Deferred tax asset, net | 3,613,307 | 3,411,544 |
| Prepaid reinsurance premiums | 20,174,981 | 13,055,893 |
| Property and equipment, net | 2,160,806 | 2,282,570 |
| Accounts receivable -- securities | 98,622 | 2,702,895 |
| Due from affiliate | -- | 546,746 |
| Other | 677,048 | 730,439 |
| Total assets | $273,128,543 | $235,704,366 |
| **Liabilities and Stockholders' Equity** | | |
| **Liabilities** | | |
| Losses and loss expenses | $110,022,886 | $ 97,733,851 |
| Unearned premiums | 66,184,188 | 54,377,239 |
| Accrued expenses | 2,140,918 | 2,373,142 |
| Current income taxes | 815,196 | -- |
| Reinsurance balances payable | 697,764 | 634,731 |
| Cash dividend declared to stockholders | 492,619 | 427,694 |
| Line of credit | 8,500,000 | 5,000,000 |
| Accounts payable -- securities | 2,498,838 | 2,491,148 |
| Other | 201,634 | 181,426 |
| Due to affiliate | 297,129 | 202,243 |
| Total liabilities | 191,851,172 | 163,421,474 |
| **Stockholders' Equity** | | |
| Preferred stock, $1.00 par value, authorized 1,000,000 shares; none issued | | |
| Common stock, $1.00 par value, authorized 10,000,000 shares, issued 4,540,569 and 4,326,362 shares and outstanding 4,471,782 and 4,261,314 shares | 4,540,569 | 4,326,362 |
| Additional paid-in capital | 37,315,888 | 35,017,965 |
| Net unrealized gains (losses) on investments available for sale, net of taxes | 420,998 | 819,213 |
| Retained earnings | 39,891,672 | 32,939,132 |
| Treasury stock, at cost | (891,756) | (819,780) |
| Total stockholders' equity | 81,277,371 | 72,282,892 |
| Total liabilities and stockholders' equity | $273,128,543 | $235,704,366 |

See accompanying notes to consolidated financial statements.

Donegal Group Inc.

Consolidated Statements of Income

| Year Ended December 31, | 1996 | 1995 | 1994 |
|---|---|---|---|
| Revenues | | | |
| Premiums earned | $138,309,092 | $115,377,302 | $101,598,330 |
| Premiums ceded | 38,327,050 | 29,099,450 | 24,365,441 |
| Net premiums earned | 99,982,042 | 86,277,852 | 77,232,889 |
| Investment income, net of investment expenses | 10,316,468 | 9,269,884 | 7,778,164 |
| Installment payment fees | 752,043 | 670,971 | 611,296 |
| Lease income | 541,010 | 491,115 | 462,587 |
| Service fees | 754,734 | 776,651 | 235,261 |
| Net realized investment gains | 172,734 | 398,587 | 34,333 |
| Total revenues | 112,519,031 | 97,885,060 | 86,354,530 |
| Expenses | | | |
| Losses and loss expenses | 91,505,086 | 72,545,223 | 70,026,135 |
| Reinsurance recoveries | 24,893,853 | 17,137,969 | 17,168,633 |
| Net losses and loss expenses | 66,611,233 | 55,407,254 | 52,857,502 |
| Amortization of deferred policy acquisition costs | 17,032,000 | 14,412,000 | 12,055,000 |
| Other underwriting expenses | 14,174,023 | 13,049,188 | 12,278,473 |
| Policy dividends | 1,549,369 | 1,106,357 | 1,349,079 |
| Other | 1,530,635 | 1,256,839 | 702,038 |
| Interest | 375,311 | 7,604 | 9,459 |
| Total expenses | 101,272,571 | 85,239,242 | 79,251,551 |
| Income before income taxes | 11,246,460 | 12,645,818 | 7,102,979 |
| Income taxes | 2,350,347 | 2,787,868 | 2,063,031 |
| Net income | $ 8,896,113 | $ 9,857,950 | $ 5,039,948 |
| Net income per common share | $ 2.01 | $ 2.31 | $ 1.20 |

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Consolidated Statements of Stockholders' Equity

| | Preferred Stock | | Common Stock | | Additional Paid-in Capital | Net Unrealized Gains (Losses) on Investments Available for Sale | Retained Earnings | Treasury Stock | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | |
| Balance, January 1, 1994 | 0 | $ 0 | 4,153,081 | $4,153,081 | $33,342,911 | $ 260,306 | $21,196,450 | $(819,780) | $58,132,968 |
| Cumulative effect of adopting SFAS No. 115 | | | | | | 1,349,670 | | | 1,349,670 |
| Issuance of common stock | | | 9,689 | 9,689 | 115,632 | | | | 125,321 |
| Net income | | | | | | | 5,039,948 | | 5,039,948 |
| Change in unrealized gains (losses) on investments (Net of applicable federal income taxes) | | | | | | (2,607,614) | | | (2,607,614) |
| Cash dividends $.36 per share | | | | | | | (1,475,226) | | (1,475,226) |
| Balance, December 31, 1994 | 0 | $ 0 | 4,162,770 | $4,162,770 | $33,458,543 | $ (997,638) | $24,761,172 | $(819,780) | $60,565,067 |
| Issuance of common stock | | | 163,592 | 163,592 | 1,559,422 | | | | 1,723,014 |
| Net income | | | | | | | 9,857,950 | | 9,857,950 |
| Change in unrealized gains (losses) on investments (Net of applicable federal income taxes) | | | | | | 1,816,851 | | | 1,816,851 |
| Cash dividends $.40 per share | | | | | | | (1,679,990) | | (1,679,990) |
| Balance, December 31, 1995 | 0 | $ 0 | 4,326,362 | $4,326,362 | $35,017,965 | $ 819,213 | $32,939,132 | $(819,780) | $72,282,892 |
| Issuance of common stock | | | 214,207 | 214,207 | 2,297,923 | | | | 2,512,130 |
| Net income | | | | | | | 8,896,113 | | 8,896,113 |
| Change in unrealized gains (losses) on investments (Net of applicable federal income taxes) | | | | | | (398,215) | | | (398,215) |
| Purchase of 3,739 shares of treasury stock | | | | | | | | (71,976) | (71,976) |
| Cash dividends $.44 per share | | | | | | | (1,943,573) | | (1,943,573) |
| Balance, December 31, 1996 | 0 | $ 0 | 4,540,569 | $4,540,569 | $37,315,888 | $ 420,998 | $39,891,672 | $(891,756) | $81,277,371 |

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Consolidated Statements of Cash Flows

| Year Ended December 31, | 1996 | 1995 | 1994 |
|---|---|---|---|
| **Cash Flows from Operating Activities:** | | | |
| Net income | $ 8,896,113 | $ 9,857,950 | $ 5,039,948 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 235,603 | 380,491 | 385,944 |
| Realized investment gains | (172,734) | (398,587) | (34,333) |
| Changes in Assets and Liabilities: | | | |
| Losses and loss expenses | 12,289,035 | 9,989,914 | 7,788,953 |
| Unearned premiums | 11,806,949 | 7,622,144 | 2,480,511 |
| Accrued expenses | (232,224) | 829,125 | (341,338) |
| Premiums receivable | 1,657,058 | (2,635,090) | (245,408) |
| Deferred policy acquisition costs | (935,681) | (1,350,349) | (462,202) |
| Deferred income taxes | 3,380 | (521,952) | (344,725) |
| Reinsurance receivable | (9,295,267) | (2,526,020) | (3,179,767) |
| Accrued investment income | (119,953) | (382,216) | (202,057) |
| Amounts due from affiliate | 843,875 | 44,961 | (243,002) |
| Reinsurance balances payable | 63,033 | (81,460) | (62,793) |
| Prepaid reinsurance premiums | (7,119,088) | (2,228,868) | (479,438) |
| Current income taxes | 1,367,186 | (675,677) | 358,824 |
| Other, net | 73,599 | (145,516) | (391,859) |
| Net adjustments | 10,464,771 | 7,920,900 | 5,027,310 |
| Net cash provided by operating activities | 19,360,884 | 17,778,850 | 10,067,258 |
| **Cash Flows from Investing Activities:** | | | |
| Purchase of fixed maturities | | | |
| Held to maturity | (30,595,807) | (26,057,540) | (5,139,055) |
| Available for sale | (21,403,083) | (27,895,537) | (27,983,885) |
| Purchase of equity securities | (9,077,146) | (6,072,439) | (7,486,343) |
| Sale of fixed maturities | | | |
| Available for sale | 7,247,675 | 5,276,380 | 22,975,319 |
| Maturity of fixed maturities | | | |
| Held to maturity | 11,596,190 | 10,996,250 | 2,637,135 |
| Available for sale | 17,634,933 | 6,631,844 | 2,627,416 |
| Sale of equity securities | 9,493,480 | 8,121,345 | 8,671,596 |
| Acquisition and assumption of Delaware | (202,243) | (5,300,000) | 5,513,259 |
| Purchase of property and equipment | (242,915) | (334,894) | (338,804) |
| Purchase of other assets | -- | -- | (131,625) |
| Net sales (purchases) of short-term investments | (6,708,924) | 12,018,979 | (9,813,495) |
| Net cash used in investing activities | (22,257,840) | (22,615,612) | (8,468,482) |
| **Cash Flows from Financing Activities:** | | | |
| Issuance of common stock | 2,512,130 | 1,723,014 | 125,321 |
| Line of credit, net | 3,500,000 | 5,000,000 | -- |
| Cash dividends paid | (1,878,648) | (1,621,631) | (1,433,270) |
| Purchase of treasury stock | (71,976) | -- | -- |
| Net cash provided by (used in) financing activities | 4,061,506 | 5,101,383 | (1,307,949) |
| Net increase in cash | 1,164,550 | 264,621 | 290,827 |
| Cash at beginning of year | 1,747,572 | 1,482,951 | 1,192,124 |
| Cash at end of year | $ 2,912,122 | $ 1,747,572 | $ 1,482,951 |

See accompanying notes to consolidated financial statements.

Donegal Group Inc.
Notes to Consolidated Financial Statements

1 -- Summary of Significant Accounting Policies

Organization and Business

The Company was organized as a regional insurance holding company by Donegal Mutual Insurance Company (the "Mutual Company") and operates in Pennsylvania, Maryland, Delaware, Virginia and Ohio through its wholly owned stock insurance companies, Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), and Delaware Atlantic Insurance Company ("Delaware"), which changed its name from Delaware American Insurance Company effective August 29, 1996 (collectively-Insurance Subsidiaries). The Company's major lines of business in 1996 and their percentages of total net earned premiums were Automobile Liability (27.7%), Workers' Compensation (18.0%), Automobile Physical Damage (16.0%), Homeowners (16.6%) and Commercial Multiple Peril (16.0%). The Insurance Subsidiaries are subject to regulation by Insurance Departments in those states in which they operate and undergo periodic examination by those departments. The Insurance Subsidiaries are also subject to competition from other insurance carriers in their operating areas. Atlantic States participates in an intercompany pooling arrangement with the Mutual Company and assumes 65% (60% in 1995 and 1994) of the pooled business. Southern cedes 50% of its business to the Mutual Company and Delaware cedes 70% of its Workers' Compensation business to the Mutual Company. At December 31, 1996, the Mutual Company held 59% of the outstanding common stock of the Company.

In addition to the Company's insurance subsidiaries, it also owns all of the outstanding stock of Atlantic Insurance Services, Inc. ("AIS"), which was formed and began business in January 1994. AIS is an insurance services organization currently providing inspection and policy auditing information on a fee for service basis to its affiliates and the insurance industry.

Basis of Consolidation

The consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles, include the accounts of Donegal Group Inc. and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The term "Company" as used herein refers to the consolidated entity. Certain amounts in the 1995 financial statements have been reclassified to conform to the current year presentation.

Use of Estimates

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

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

Investments

The Company accounts for investments in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which was adopted January 1, 1994.

SFAS No. 115 requires that investments in all debt securities and those equity securities with readily determinable market values be classified into three categories as follows:

Held to Maturity -- Debt securities that the Company has the positive intent and ability to hold to maturity; reported at amortized cost.

Trading -- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term; reported at fair value, with unrealized gains and losses included in income.

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

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

If there is a decline in fair value which is other than temporary, the carrying value for investments in the held to maturity and available for sale categories is reduced to fair value. Such decline in carrying value is recognized as a realized loss and charged to income. Premiums and discounts on debt securities are amortized over the life of the security as an adjustment to yield using the effective interest method. Realized investment gains and losses are computed using the specific identification method.

Premiums and discounts for mortgaged-backed debt securities are amortized using anticipated prepayments with significant changes in estimated prepayments accounted for under the prospective method.

Fair Values of Financial Instruments

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

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

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

Property and equipment are reported at depreciated cost that is computed using the straight-line method based upon estimated useful lives of the assets, ranging from 3 to 15 years.

Losses and Loss Expenses

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

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

In addition, various Insurance Departments, as an integral part of their examination process, periodically review the Company's liabilities for losses and loss expenses. Such departments may require the Company to recognize additions to the liabilities based on their judgements about information available to them at the time of their examination.

The Company has no material exposures to environmental liabilities.

Income Taxes

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

The Company accounts for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled.

Credit Risk

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

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

Reinsurance Accounting and Reporting

The Company relies upon reinsurance agreements to limit its maximum net loss from large single risks or risks in concentrated areas, and to increase its

capacity to write insurance.

Reinsurance does not relieve the primary insurer from liability to its policyholders. To the extent that a reinsurer may be unable to pay losses for which it is liable under the terms of a reinsurance agreement, the Company is exposed to the risk of continued liability for such losses. However, in an effort to reduce the risk of non-payment, the Company requires all of its reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition which, in the opinion of management, is equivalent to a company with at least an A- rating. If the Company's reinsurers incur losses from their reinsurance arrangements with the Company, it is probable that the reinsurance premiums payable by the Company in the future could increase. Estimated amounts of reinsurance recoverable are reported as assets in the accompanying consolidated balance sheets as are prepaid reinsurance premiums which represent the unearned portion of premiums ceded.

Stock-Based Compensation

Stock-based compensation plans are accounted for under the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. As such, compensation expense would be recorded on the date of a stock option grant only if the current market price of the underlying stock exceeded the exercise price. Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-based Compensation" is effective for 1996 and permits entities to recognize as expense, over the vesting period, the fair value of all stock-based awards on the date of the grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosures under SFAS No. 123.

Net Income per Common Share

Net income per share is based upon the weighted average number of common shares outstanding plus dilutive common equivalent shares from stock options using the treasury stock method.

The average common and common equivalent shares outstanding for the years ended December 31, 1996, 1995 and 1994, were 4,425,652, 4,272,447 and 4,181,159, respectively.

2 -- Transactions with Affiliates

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

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States cedes to the Mutual Company all of its insurance business and assumes from the Mutual Company 65% (60% in 1995 and 1994) of the Mutual Company's total pooled insurance business, including that assumed from Atlantic States and substantially all of the business assumed and retained by the Mutual Company from Southern and Delaware. Atlantic States, Southern and Delaware each have a catastrophe reinsurance agreement with the Mutual Company which limits the maximum liability under any one catastrophic occurrence to $400,000, $300,000 and $300,000, respectively, and $700,000 for a catastrophe involving more than one of the companies. The Mutual Company and Delaware also have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $200,000 of losses in excess of $50,000 and Workers' Compensation quota share agreement whereby Delaware cedes 70% of that business. The Mutual Company and Southern have an excess of loss reinsurance agreement in which the Mutual Company assumes up to $25,000 of losses in excess of $100,000 and a quota share agreement whereby Southern cedes 50% of its direct business less certain reinsurance to the Mutual Company. Both Southern and Delaware have retrocessional reinsurance agreements effective July 1, 1996 with the Mutual Company under which they cede, and then assume back, 100% of their business net of other reinsurance.

The following amounts represent reinsurance transactions with the Mutual Company during 1996, 1995 and 1994. Amounts for losses and loss expenses exclude salvage and subrogation recoverable because such amounts are determined on a net basis only consistent with the Mutual Company's statutory records:

| Ceded reinsurance: | 1996 | 1995 | 1994 |
|---|---|---|---|
| Premiums written | $ 41,696,471 | $27,731,104 | $22,792,131 |
| Premiums earned | $ 34,602,528 | $25,555,026 | $21,274,804 |
| Losses and loss expenses | $ 23,137,013 | $14,336,897 | $14,643,183 |
| Unearned premiums | $ 19,500,015 | $12,406,072 | $10,229,994 |
| Liability for losses and loss expenses | $ 31,381,875 | $20,855,048 | $18,476,791 |
| **Assumed reinsurance:** | | | |
| Premiums written | $104,549,034 | $79,550,369 | $69,196,807 |

| | | | |
|---|---|---|---|
| Premiums earned | $ 93,649,895 | $74,824,803 | $66,322,464 |
| Losses and loss expenses | $ 63,840,301 | $49,332,144 | $45,544,081 |
| Unearned premiums | $ 46,009,207 | $35,110,068 | $30,384,502 |
| Liability for losses and loss expenses | $ 78,341,967 | $66,020,750 | $57,267,708 |

Losses and loss expenses assumed from the Mutual Company for 1996, 1995 and 1994 are reported net of intercompany catastrophe recoveries which amounted to approximately $9.5 million, $0 and $2.8 million, respectively.

b. Expense Sharing

The Mutual Company provides facilities, management and other services to the Company, and the Company reimburses the Mutual Company for such services on a periodic basis under usage agreements and pooling arrangements. The charges are based upon the relative participation of the Company and the Mutual Company in the pooling arrangement, and management of both the Company and the Mutual Company consider this allocation to be reasonable. Charges for these services totalled $18,878,506, $16,886,631 and $13,708,490 for 1996, 1995 and 1994, respectively.

c. Lease Agreement

The Company leases office equipment and automobiles to The Mutual Company under a 10-year lease dated January 1, 1990.

Future annual commitments under these leases are $537,000 for 1997, 1998 and 1999.

d. Inspection and Policy Auditing Services

AIS provides inspection and policy auditing services to the Mutual Company on a fee for service basis.

3 -- Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 1996 and 1995, are as follows:

| | 1996 | | | |
|---|---|---|---|---|
| HELD TO MATURITY | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 37,393,590 | $ 234,456 | $292,696 | $ 37,335,350 |
| Obligations of states and political subdivisions | 55,989,476 | 1,764,831 | 74,988 | 57,679,319 |
| Corporate securities | 5,766,899 | 278,056 | 8,455 | 6,036,500 |
| Mortgage-backed securities | 12,431,197 | 128,691 | 149,840 | 12,410,048 |
| Totals | $111,581,162 | $2,406,034 | $525,979 | $113,461,217 |

| | 1996 | | | |
|---|---|---|---|---|
| AVAILABLE FOR SALE | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $32,824,112 | $ 34,564 | $149,582 | $32,709,094 |
| Obligations of states and political subdivisions | 12,287,823 | 406,867 | 13,190 | 12,681,500 |
| Corporate securities | 3,107,680 | -- | 20,680 | 3,087,000 |
| Mortgage-backed securities | 1,094,905 | 16,044 | -- | 1,110,949 |
| Equity securities | 2,770,346 | 475,165 | 111,313 | 3,134,198 |
| Totals | $52,084,866 | $932,640 | $294,765 | $52,722,741 |

| | 1995 | | | |
|---|---|---|---|---|
| | Amortized | Gross Unrealized | Gross Unrealized | Estimated Fair |

| HELD TO MATURITY | Cost | Gains | Losses | Value |
|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $19,675,694 | $ 467,842 | $ 48,036 | $20,095,500 |
| Obligations of states and political subdivisions | 52,080,590 | 2,378,670 | 29,155 | 54,430,105 |
| Corporate securities | 3,816,309 | 380,980 | 2,289 | 4,195,000 |
| Mortgage-backed securities | 16,406,529 | 288,082 | 57,376 | 16,637,235 |
| Totals | $91,979,122 | $3,515,574 | $136,856 | $95,357,840 |

1995

| AVAILABLE FOR SALE | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|---|---|---|---|---|
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $35,057,293 | $ 374,436 | $ 10,286 | $35,421,443 |
| Obligations of states and political subdivisions | 9,633,046 | 486,704 | -- | 10,119,750 |
| Corporate securities | 4,299,597 | 55,273 | 6,870 | 4,348,000 |
| Mortgage-backed securities | 1,724,951 | 32,586 | -- | 1,757,537 |
| Equity securities | 2,954,487 | 413,878 | 104,487 | 3,263,878 |
| Totals | $53,669,374 | $1,362,877 | $121,643 | $54,910,608 |

The amortized cost and estimated fair value of fixed maturities at December 31, 1996, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Estimated Fair Value |
|---|---|---|
| Held to maturity | | |
| Due in one year or less | $ 5,615,296 | $ 5,661,000 |
| Due after one year through five years | 23,801,976 | 24,161,000 |
| Due after five years through ten years | 33,727,321 | 34,110,100 |
| Due after ten years | 36,005,372 | 37,119,069 |
| Mortgage-backed securities | 12,431,197 | 12,410,048 |
| Total held to maturity | $111,581,162 | $113,461,217 |
| Available for sale | | |
| Due in one year or less | $ 6,994,864 | $ 7,000,000 |
| Due after one year through five years | 21,090,113 | 21,033,594 |
| Due after five years through ten years | 9,867,026 | 9,899,000 |
| Due after ten years | 10,267,612 | 10,545,000 |
| Mortgage-backed securities | 1,094,905 | 1,110,949 |
| Total available for sale | $ 49,314,520 | $ 49,588,543 |

Net change in unrealized investment gains (losses) less applicable federal income taxes is as follows:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Fixed maturities | $ (657,819) | $ 1,657,442 | $(2,664,358) |
| Equity securities | 54,461 | 1,004,643 | (1,185,026) |
| Deferred federal income (taxes) benefit | 205,143 | (845,234) | 1,241,770 |
| Net change | $ (398,215) | $ 1,816,851 | $(2,607,614) |
| Held to maturity | $(1,498,661) | $ 6,252,155 | $(6,949,719) |

Unrealized investment gains (losses) less applicable federal income taxes are as follows:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Fixed maturities | | | |
| Gains | $ 457,475 | $ 948,999 | $ 112,093 |
| Losses | (183,452) | (17,156) | (837,695) |
| Equity securities | | | |
| Gains | 475,165 | 413,877 | 49,075 |
| Losses | (111,313) | (104,487) | (744,325) |
| | 637,875 | 1,241,233 | (1,420,852) |
| Deferred federal income (taxes) benefit | (216,877) | (422,020) | 423,214 |
| Net unrealized investment gains (losses) | $ 420,998 | $ 819,213 | $ (997,638) |

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

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Fixed maturities | $ 9,513,417 | $8,264,968 | $6,681,435 |
| Equity securities | 233,072 | 233,822 | 230,530 |
| Short-term investments | 1,034,246 | 1,194,082 | 1,286,290 |
| Real estate | 29,250 | 29,250 | 29,310 |
| Investment income | 10,809,985 | 9,722,122 | 8,227,565 |
| Investment expenses | 493,517 | 452,238 | 449,401 |
| Net investment income | $10,316,468 | $9,269,884 | $7,778,164 |

Proceeds and gross realized gains (losses) from sales of investments during 1996, 1995 and 1994 are as follows:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Proceeds | $14,136,882 | $13,409,224 | $30,615,578 |
| Gross realized gains: | | | |
| Fixed maturities | 29,206 | 347,020 | 410,687 |
| Equity securities | 404,381 | 658,595 | 675,008 |
| | 433,587 | 1,005,615 | 1,085,695 |
| Gross realized losses: | | | |
| Fixed maturities | 689 | 1,152 | 831,412 |
| Equity securities | 260,164 | 605,876 | 219,950 |
| | 260,853 | 607,028 | 1,051,362 |

| | | | |
|---|---|---|---|
| Net realized gains | $ 172,734 | $ 398,587 | $ 34,333 |

During 1995, as permitted by the Financial Accounting Standards Board "one-time window," the Company transferred $4,101,469 of investments from the held to maturity to the available for sale portfolio. The fair value of such investments was $4,381,217. This transfer was made to provide the Company with increased flexibility in managing its liquidity position.

4 -- Deferred Policy Acquisition Costs

Changes in deferred policy acquisition costs are as follows:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Balance, January 1 | $ 6,902,218 | $ 5,551,869 | $ 5,089,667 |
| Acquisition costs deferred | 17,967,681 | 15,762,349 | 12,517,202 |
| Amortization charged to earnings | 17,032,000 | 14,412,000 | 12,055,000 |
| Balance, December 31 | $ 7,837,899 | $ 6,902,218 | $ 5,551,869 |

5 -- Property and Equipment

Property and equipment at December 31, 1996 and 1995, consisted of the following:

| | 1996 | 1995 |
|---|---|---|
| Cost -- office equipment | $ 2,253,581 | $ 2,204,608 |
| automobiles | 769,767 | 721,565 |
| leasehold improvements | 81,719 | 81,719 |
| land | 610,010 | 610,010 |
| software | 18,409 | 2,067 |
| | 3,733,486 | 3,619,969 |
| Accumulated depreciation | (1,572,680) | (1,337,399) |
| | $ 2,160,806 | $ 2,282,570 |

Depreciation expense for 1996, 1995 and 1994 amounted to $364,679, $345,408 and $351,951, respectively.

6 -- Liability for Losses and Loss Expenses

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

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Balance at January 1 | $ 97,733,851 | $ 87,743,937 | $ 69,441,728 |
| Less reinsurance recoverable | 27,693,106 | 25,167,086 | 17,143,860 |
| Net Balance at January 1 | 70,040,745 | 62,576,851 | 52,297,868 |
| Acquisition of Delaware American | -- | -- | 5,669,797 |
| Net Balance at January 1 as restated | 70,040,745 | 62,576,851 | 57,967,665 |
| Incurred related to: | | | |
| Current year | 69,206,233 | 58,354,254 | 55,941,502 |
| Prior years | (2,595,000) | (2,947,000) | (3,084,000) |
| Total incurred | 66,611,233 | 55,407,254 | 52,857,502 |
| Paid related to: | | | |
| Current year | 39,988,258 | 28,934,360 | 30,544,316 |
| Prior years | 22,889,000 | 19,009,000 | 17,704,000 |
| Total paid | 62,877,258 | 47,943,360 | 48,248,316 |
| Net Balance at December 31 | 73,774,720 | 70,040,745 | 62,576,851 |
| Plus reinsurance recoverable | 36,248,166 | 27,693,106 | 25,167,086 |
| Balance at December 31 | $ 110,022,886 | $ 97,733,851 | $ 87,743,937 |

The Company recognized a decrease in the liability for losses and loss expenses (favorable development) of $2.6 million, $3.0 million and $3.1 million. These favorable developments are primarily attributable to the Company's strengthening of case reserves in prior years, the effects of which are being recognized currently.

7 -- Line of Credit

At December 31, 1996, pursuant to a credit agreement dated December 29, 1995, with Fleet National Bank of Connecticut, the Company had unsecured borrowings of $8.5 million. Such borrowings were made in connection with the acquisition of Delaware and a $5 million capital contribution to Atlantic States. Per the terms of the credit agreement, the Company may borrow up to $20 million at interest rates equal to the bank's then current prime rate or the then current London interbank Eurodollar bank rate plus 1.70%. At December 31, 1996, the interest rate on the outstanding balance was 7.325%. In addition, the Company will pay a non-use fee at a rate of 3/10 of 1% per annum on the average daily unused portion of the Bank's commitment. On each December 29, commencing December 29, 1998, the credit line will be reduced by $4 million. Any outstanding loan in excess of the remaining credit line, after such reduction, will then be payable.

8 -- Unaffiliated Reinsurers

In addition to the primary reinsurance in place with the Mutual Company, the Insurance Subsidiaries have other reinsurance in place principally with four unaffiliated reinsurers. The following amounts represent statutory reinsurance transactions with unaffiliated reinsurers during 1996, 1995 and 1994:

| Ceded reinsurance: | 1996 | 1995 | 1994 |
|---|---|---|---|
| Premiums written | $3,749,667 | $3,597,212 | $3,062,180 |
| Premiums earned | $3,724,522 | $3,544,424 | $4,090,637 |
| Losses and loss expenses | $1,756,840 | $2,801,073 | $2,531,806 |
| Unearned premiums | $ 674,966 | $ 649,821 | $ 597,031 |
| Liability for losses and loss expenses | $4,866,291 | $6,838,058 | $6,690,295 |

9 -- Federal Income Taxes

The provision for federal income tax consists of the following:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Current | $2,346,967 | $ 3,309,820 | $ 2,407,756 |
| Deferred | 3,380 | (521,952) | (344,725) |
| Federal tax provision | $2,350,347 | $ 2,787,868 | $ 2,063,031 |

The effective tax rate is different than the amount computed at the

statutory federal rate of 34% for 1996, 1995 and 1994. The reason for such difference and the related tax effect are as follows:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Income before income taxes | $11,246,460 | $12,645,818 | $7,102,979 |
| Computed "expected" taxes at 34% | $ 3,823,796 | $ 4,299,578 | $2,415,013 |
| Tax-exempt interest | (1,055,491) | (751,003) | (671,969) |
| Dividends received deduction | (48,108) | (46,789) | (52,993) |
| Deduction for exercise of options | (399,904) | (324,254) | -- |
| Other, net | 30,054 | (5,998) | (16,659) |
| Delaware loss not providing current tax benefit | -- | -- | 356,321 |
| Change in valuation allowance | -- | (383,669) | -- |
| Federal income tax provision | $ 2,350,347 | $ 2,787,868 | $2,063,031 |

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1996 and 1995, are as follows:

| | 1996 | 1995 |
|---|---|---|
| Deferred tax assets: | | |
| Unearned premium | $3,128,626 | $2,809,850 |
| Loss reserves | 3,910,691 | 3,810,076 |
| Total | $7,039,317 | $6,619,926 |
| Deferred tax liabilities: | | |
| Depreciation expense | $ 286,816 | $ 273,919 |
| Deferred policy acquisition costs | 2,664,886 | 2,346,754 |
| Salvage receivable | 257,431 | 165,689 |
| Unrealized gain | 216,877 | 422,020 |
| Total | $3,426,010 | $3,208,382 |
| Net deferred tax assets | $3,613,307 | $3,411,544 |

A valuation allowance is provided when it is more likely than not that some portion of the tax asset will not be realized. Management has determined that it is not required to establish a valuation allowance for the deferred tax asset of $7,039,317 and $6,619,926 at December 31, 1996 and 1995 since it is more likely than not that the deferred tax asset will be realized through reversals of existing temporary differences, future taxable income, carryback to taxable income in prior years, previously realized investment gains and the implementation of tax planning strategies. The net change in the valuation allowance for the year ended December 31, 1995 was a decrease of $383,669.

10 -- Stock Compensation Plans

The Company applies APB Opinion 25 in accounting for its stock-based compensation plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and certain of its stock purchase plans. Compensation cost for these stock-based compensation plans determined under SFAS No. 123 would not have had a material impact on net income and earnings per share for 1996 or 1995.

The calculation of pro forma net income reflects only options granted in 1996 and 1995. Therefore, the full impact of calculating compensation cost for stock options under SFAS No. 123 is not reflected because compensation cost is reflected over the options' vesting period and compensation cost for options granted prior to January 1, 1995 is not considered.

Equity Incentive Plans

The Company has had an Equity Incentive Plan for key employees since 1986 and adopted a nearly identical new plan in 1996. Both plans provide for the granting of awards by the Board of Directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. During 1994 the aggregate number of shares available as awards was increased from 450,000 to 700,000. During 1996 the new plan was adopted and it makes 345,850 shares available. The plans provide that stock options may become exercisable up to 10 years from date of grant, with an option price not less than fair market value on date of grant. The stock appreciation rights permit surrender of the option and receipt of the excess of current market price over option price in cash.

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

| | Number of Shares | Weighted Average Exercise Price Per Share |
|---|---|---|
| Outstanding at December 31, 1993 | 360,650 | $ 11.01 |
| Granted -- 1994 | -- | -- |
| Exercised -- 1994 | -- | -- |
| Forfeited -- 1994 | -- | -- |
| Outstanding at December 31, 1994 | 360,650 | $ 11.01 |
| Granted -- 1995 | -- | -- |
| Exercised -- 1995 | 150,650 | 10.47 |
| Forfeited -- 1995 | 7,500 | 10.80 |
| Outstanding at December 31, 1995 | 202,500 | $ 11.42 |
| Granted -- 1996 | -- | -- |
| Exercised -- 1996 | 202,500 | 11.42 |
| Forfeited -- 1996 | -- | -- |
| Outstanding at December 31, 1996 | -- | $ -- |
| Exercisable at: | | |
| December 31, 1995 | 202,500 | $ 11.42 |
| December 31, 1996 | -- | $ -- |

As of December 31, 1996, the Company has no unexercised options under this plan.

Shares available for future grants at December 31, 1996, are 345,850.

1996 Equity Incentive Plan For Directors

During 1996 the Company adopted an Equity Incentive Plan For Directors which makes 90,000 shares available for award. Awards may be made in the form of stock options and additionally provides for the issuance of 100 shares of restricted stock to each director on the first business day of January in each year, commencing January 2, 1997. As of December 31, 1996 the Company has no outstanding options under this plan.

Employee Stock Purchase Plans

During 1996 the Company adopted the 1996 Employee Stock Purchase Plan which replaced a similar plan that had been adopted effective January 1, 1988. The 1996 plan makes 100,000 shares available for issuance.

The 1996 Plan extends over a 10-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85 percent of the fair market value of the Company's common stock on the last day before the first day of the enrollment period (June 1 and December 1) of the plan or 85 percent of the fair market value of such share on the last day of the subscription period (June 30 and December 31). A summary of plan activity follows:

| | Shares Issued | |
|---|---|---|
| | Price | Shares |
| January 1, 1994 | 13.175 | 4,205 |
| July 1, 1994 | 12.75 | 5,484 |
| January 1, 1995 | 11.90 | 6,004 |
| July 1, 1995 | 10.625 | 6,938 |
| January 1, 1996 | 14.2375 | 5,630 |
| July 1, 1996 | 14.6625 | 6,077 |

On January 1, 1997, the Company issued an additional 6,575 shares at a price of $14.6625 per share under this plan.

Agency Stock Purchase Plan

On December 31, 1996 the Company adopted the Agency Stock Purchase Plan which makes 300,000 shares available for issuance. The plan provides for agents of affiliated companies of Donegal Group Inc. to invest up to $12,000 per subscription period (April 1 to September 30 and October 1 to March 31) under various methods. Stock is issued at the end of the subscription period at a price equal to 90% of the average market price during the last ten trading days of the subscription period.

11 -- Statutory Net Income Capital and Surplus and Dividend Restrictions

The following is selected information for the Insurance Subsidiaries as determined in accordance with accounting practices prescribed or permitted by insurance regulatory authorities.

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| ATLANTIC STATES | | | |
| Statutory capital and surplus | $47,914,415 | $40,726,246 | $38,481,691 |
| Statutory unassigned surplus | $16,953,551 | $14,765,382 | $12,520,827 |
| Statutory net income | $ 5,410,536 | $ 5,224,905 | $ 4,072,387 |

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| SOUTHERN | | | |
| Statutory capital and surplus | $6,608,944 | $6,380,420 | $5,833,556 |
| Statutory unassigned surplus | $1,856,674 | $2,378,150 | $1,831,285 |
| Statutory net income | $ 255,480 | $ 679,335 | $ 764,696 |

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| DELAWARE | | | |
| Statutory capital and surplus | $6,798,477 | $5,695,634 | $5,016,599 |
| Statutory unassigned surplus | $1,598,477 | $ 495,634 | $ (183,401) |
| Statutory net income (loss) | $1,120,952 | $ 494,576 | $ (963,982) |

The Company's principal source of cash for payment of dividends are dividends from its Insurance Subsidiaries which are required by law to maintain certain minimum capital and surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Atlantic States, Southern and Delaware are also subject to risk based capital (RBC) requirements which may further impact their ability to pay dividends. At December 31, 1996, all three Companies' statutory capital and surplus were substantially above the RBC requirements. At December 31, 1996, amounts available for distribution as dividends to Donegal Group Inc. without prior approval of insurance regulatory authorities are $5,410,536 from Atlantic

States, $255,480 from Southern and $1,120,952 from Delaware.

12 -- Reconciliation of Statutory Filings to Amounts Reported Herein

The Company's Insurance Subsidiaries are required to file statutory financial statements with state insurance regulatory authorities. Accounting principles used to prepare these statutory financial statements differ from financial statements prepared on the basis of generally accepted accounting principles.

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

| | Year ended December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| Statutory net income of insurance subsidiaries | $6,786,968 | $6,398,816 | $3,873,101 |
| Increases (decreases): | | | |
| Deferred policy acquisition costs | 935,681 | 1,350,349 | 462,202 |
| Deferred federal income taxes | (3,380) | 521,952 | 344,725 |
| Salvage and subrogation recoverable | 1,037,926 | 1,150,509 | 337,188 |
| Consolidating eliminations and adjustments | -- | (900,000) | (900,000) |
| Parent only net income | 155,894 | 1,301,558 | 952,697 |
| Non-insurance subsidiary net income (loss) | (16,976) | 34,766 | (29,965) |
| Net income as reported herein | $8,896,113 | $9,857,950 | $5,039,948 |

| | December 31, | | |
|---|---|---|---|
| | 1996 | 1995 | 1994 |
| Statutory capital and surplus of insurance subsidiaries | $ 61,321,836 | $52,802,300 | $49,331,846 |
| Increases (decreases): | | | |
| Deferred policy acquisition costs | 7,837,899 | 6,902,218 | 5,551,869 |
| Deferred federal income taxes | 3,613,307 | 3,411,544 | 3,734,826 |
| Salvage and subrogation recoverable | 4,918,547 | 3,880,621 | 2,730,112 |
| Statutory reserves | 9,835,700 | 6,413,472 | 3,446,574 |
| Non-admitted assets and other adjustments, net | 339,781 | 440,116 | 374,009 |
| Fixed maturities available for sale | 274,023 | 931,843 | (725,600) |
| Consolidating eliminations and adjustments | (10,929,937) | (5,929,937) | (5,871,578) |
| Parent only equity | 3,878,390 | 3,225,914 | 1,822,974 |
| Non-insurance subsidiary equity | 187,825 | 204,801 | 170,035 |
| Stockholders' equity as reported herein | $ 81,277,371 | $72,282,892 | $60,565,067 |

13 -- Supplementary Information on Statement of Cash Flows

The following schedule reflects income taxes and interest paid during 1996, 1995 and 1994:

| | 1996 | 1995 | 1994 |
|---|---|---|---|
| Income taxes | $983,161 | $3,985,497 | $2,072,512 |
| Interest | $369,869 | $ 7,229 | $ 9,459 |

14 -- Interim Financial Data (unaudited)

| 1996 | | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net premiums earned | $24,695,309 | $24,835,041 | $25,134,567 | $25,317,125 |
| Total revenues | 27,898,782 | 27,857,986 | 28,176,395 | 28,585,868 |
| Loss and loss adjusting expenses | 17,793,237 | 16,147,754 | 16,185,048 | 16,485,194 |
| Net income | 1,410,932 | 2,720,429 | 2,485,311 | 2,279,441 |
| Net income per common share | $.32 | $.62 | $.56 | $.51 |

| 1995 | | | | |
|---|---|---|---|---|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Net premiums earned | $20,333,148 | $21,353,648 | $22,026,028 | $22,565,028 |

| | | | | |
|---|---|---|---|---|
| Total revenues | 23,008,266 | 24,312,402 | 25,034,119 | 25,530,273 |
| Loss and loss adjusting expenses | 12,455,415 | 14,215,193 | 14,240,198 | 14,496,448 |
| Net income | 2,430,125 | 2,500,700 | 2,349,118 | 2,578,007 |
| Net income per common share | $ .58 | $ .59 | $ .55 | $ .59 |

Results for the first quarter of 1996 were adversely affected due to the record snow levels in the Company's operating area that fell in January 1996. This resulted in a loss ratio of 72.1% in the first quarter compared to 64.8% for the rest of the year.

15 -- Pending Acquisition

On December 22, 1994, the Company announced its intent to purchase all of the outstanding shares of Pioneer Insurance Company from the Mutual Company. The purchase price is expected to approximate statutory book value, which at December 31, 1996, was $5,048,582. The acquisition will be accounted for as if it were a pooling of interests. It is anticipated that the acquisition will be consummated on April 1, 1997.

Donegal Group Inc.

Independent Auditors' Report

The Stockholders and Board of Directors
Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. as of December 31, 1996 and 1995, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1996. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. as of December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1996 in conformity with generally accepted accounting principles.

KPMG Peat Marwick LLP

Harrisburg, Pennsylvania
March 3, 1997

DONEGAL GROUP INC.

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD APRIL 17, 1997

To the Stockholders of
DONEGAL GROUP INC.:

The Annual Meeting of Stockholders of Donegal Group Inc. (the "Company") will be held at 10:00 a.m., prevailing time, on April 17, 1997, at the Company's offices, 1195 River Road, Marietta, Pennsylvania 17547, for the following purposes:

1. To elect two Class B directors to serve until the expiration of their three-year terms and until their successors are elected;

2. To act upon the election of KPMG Peat Marwick LLP as independent public accountants for the Company for 1997;

3. To consider and vote upon a proposal to adopt the Company's Amended and Restated 1996 Equity Incentive Plan for officers and key employees;

4. To consider and vote upon a proposal to adopt the Company's 1996 Equity Incentive Plan for Directors; and

5. To transact such other business as may properly come before the Annual Meeting and any adjournment, postponement or continuation thereof.

The Board of Directors has fixed the close of business on February 21, 1997 as the record date for the determination of the stockholders entitled to notice of and to vote at the Annual Meeting.

A copy of the Company's Annual Report for the year ended December 31, 1996 is being mailed to stockholders together with this Notice.

Holders of Common Stock are requested to complete, sign and return the enclosed form of proxy in the envelope provided whether or not they expect to attend the Annual Meeting in person.

By Order of the Board of Directors,

/s/ Donald H. Nikolaus

Donald H. Nikolaus,
President and Chief Executive Officer

March 24, 1997
Marietta, Pennsylvania

DONEGAL GROUP INC.

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This Proxy Statement and the form of proxy enclosed herewith, which are first being mailed to stockholders on or about March 24, 1997, are furnished in connection with the solicitation by the Board of Directors of Donegal Group Inc. (the "Company") of proxies to be voted at the Annual Meeting of Stockholders (the "Annual Meeting") to be held at 10:00 a.m., prevailing time, on April 17, 1997, and at any adjournment, postponement or continuation thereof, at the Company's principal executive offices, which are located at 1195 River Road, Marietta, Pennsylvania 17547.

Shares represented by proxies in the accompanying form, if properly signed and returned, will be voted in accordance with the specifications made thereon by the stockholders. Any proxy not specifying to the contrary will be voted in favor of the adoption of the proposals referred to in the Notice of Annual Meeting and for the election of the nominees for director named below. A stockholder who signs and returns a proxy in the accompanying form may revoke it at any time before it is voted by giving written notice of revocation or a duly executed proxy bearing a later date to the Secretary of the Company or by attending the Annual Meeting and voting in person.

The cost of solicitation of proxies in the accompanying form will be borne by the Company, including expenses in connection with preparing and mailing this Proxy Statement. Such solicitation will be made by mail and may also be made on behalf of the Company in person or by telephone or telegram by the Company's regular officers and employees, none of whom will receive special compensation for such services. The Company, upon request therefor, will also reimburse brokers, nominees, fiduciaries and custodians and persons holding shares in their names or in the names of nominees for their reasonable expenses in sending proxies and proxy material to beneficial owners.

Only holders of Common Stock of record at the close of business on February 21, 1997 will be entitled to notice of and to vote at the Annual Meeting. Each share of Common Stock is entitled to one vote on all matters to come before the Annual Meeting. Cumulative voting rights do not exist with respect to the election of directors.

As of the close of business on February 21, 1997, the Company had outstanding 4,479,557 shares of Common Stock, $1.00 par value. A majority of the outstanding shares will constitute a quorum at the Annual Meeting. As of February 21, 1997, Donegal Mutual Insurance Company (the "Mutual Company") owned 2,621,633 shares of the Company's outstanding Common Stock, or approximately 58.5% of the Company's outstanding Common Stock. The Mutual Company has advised the Company that the Mutual Company will vote its shares for the election of C. Edwin Ireland and Donald H. Nikolaus as Class B directors, for the election of KPMG Peat Marwick LLP as the Company's independent public accountants for 1997, for the adoption of the Amended and Restated 1996 Equity Incentive Plan (the "1996 Equity Incentive Plan") and for the adoption of the 1996 Equity Incentive Plan for Directors (the "1996 Director Plan"). Accordingly, Messrs. Ireland and Nikolaus will be elected as Class B directors, KPMG Peat Marwick LLP will be elected as the Company's independent public accountants for 1997 and the 1996 Equity Incentive Plan and the 1996 Director Plan will be approved regardless of the votes of the Company's stockholders other than the Mutual Company.

## BENEFICIAL OWNERSHIP OF COMMON STOCK

The following table sets forth as of February 21, 1997 the amount and percentage of the Company's outstanding Common Stock beneficially owned by (i) each person who is known by the Company to own beneficially more than 5% of its outstanding Common Stock, (ii) each director and nominee for director, (iii) each executive officer named in the Summary Compensation Table and (iv) all executive officers and directors of the Company as a group.

| NAME OF INDIVIDUAL OR IDENTITY OF GROUP | SHARES BENEFICIALLY OWNED(1) | PERCENT OF OUTSTANDING COMMON STOCK(2) |
|---|---|---|
| 5% HOLDERS: | | |
| Donegal Mutual Insurance Company<br>1195 River Road<br>Marietta, Pennsylvania 17547 | 2,621,633 | 58.5% |
| DIRECTORS: | | |
| C. Edwin Ireland | 7,767(4) | -- |
| Donald H. Nikolaus | 53,490(5) | 1.2% |
| Patricia A. Gilmartin | 2,967(4) | -- |
| Philip H. Glatfelter, II | 3,167(4) | -- |
| R. Richard Sherbahn | 1,867(4) | -- |
| Robert S. Bolinger | 2,367(4) | -- |
| Thomas J. Finley, Jr | 2,217(4) | -- |
| EXECUTIVE OFFICERS (3): | | |
| Ralph G. Spontak | 20,083(6) | -- |
| William H. Shupert | 10,106(7) | -- |
| Frank J. Wood | 5,647(8) | -- |
| Robert Shenk | 7,160(9) | -- |
| All directors and executive officers as a group (13 persons) | 128,644(10) | 2.9% |

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(1) Information furnished by each individual named. This table includes shares that are owned jointly, in whole or in part, with the person's spouse, or individually by his spouse.

(2) Less than 1% unless otherwise indicated.

(3) Excludes Executive Officers listed under "Directors."

(4) Includes 1,667 shares of Common Stock the director has the option to purchase under the 1996 Director Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Director Plan by the stockholders at the Annual Meeting.

(5) Includes 25,000 shares of Common Stock Mr. Nikolaus has the option to purchase under the Company's 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan by the stockholders at the Annual Meeting.

(6) Includes 12,500 shares of Common Stock Mr. Spontak has the option to purchase under the Company's 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan by the stockholders at the Annual Meeting.

(7) Includes 7,000 shares of Common Stock Mr. Shupert has the option to purchase under the Company's 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan by the stockholders at the Annual Meeting.

(8) Includes 5,000 shares of Common Stock Mr. Wood has the option to purchase under the Company's 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan by the stockholders at the Annual Meeting.

(9) Includes 5,000 shares of Common Stock Mr. Shenk has the option to purchase under the Company's 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan by the stockholders at the Annual Meeting.

(10) Includes 62,834 shares of Common Stock purchasable upon the exercise of options granted under the 1996 Equity Incentive Plan, which become exercisable on and after April 30, 1997, and 10,002 shares of Common Stock purchasable upon the exercise of options granted under the 1996 Director Plan, which become exercisable on and after April 30, 1997, subject to adoption of the 1996 Equity Incentive Plan and the 1996 Director Plan by the stockholders at the Annual Meeting.

## SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act") requires that the officers and directors of a corporation, such as the Company, which has a class of equity securities registered under Section 12 of the Exchange Act, as well as persons who own more than 10% of a class of equity securities of such a corporation, file reports of their ownership of such securities, as well as monthly statements of changes in such ownership, with the corporation, the Securities and Exchange Commission (the "SEC") and Nasdaq. Based upon written representations received by the Company from its officers and directors, and the Company's review of the monthly statements of ownership changes filed with the Company by its officers and directors during 1996, the Company believes that all such filings required during 1996 were made on a timely basis.

## RELATIONSHIP WITH THE MUTUAL COMPANY

The Company was formed by the Mutual Company in August 1986 and was a wholly owned subsidiary of the Mutual Company until November 1986, when the Company sold 600,000 shares of Common Stock in a public offering, thereby reducing the Mutual Company's ownership of the Company's outstanding Common Stock from 100% to approximately 79.5%, which subsequently increased to approximately 84%. In September 1993, the Company sold 1,150,000 shares of Common Stock in a public offering. At the same time, the Mutual Company sold 200,000 shares of the Company's Common Stock, reducing the Mutual Company's ownership of the Company's outstanding Common Stock to approximately 57%. Between December 22, 1994 and December 31, 1995, the Mutual Company purchased an aggregate of 172,000 shares of the Company's Common Stock in the open market in exempt transactions under SEC rule 10b-18 and in private transactions. Between December 31, 1995 and December 31, 1996, the Mutual Company purchased an aggregate of 114,000 shares of the Company's Common Stock in private transactions. These purchases increased the Mutual Company's ownership of the Company's Common Stock to 2,621,633 shares or approximately 58.5% of the Company's outstanding Common Stock as of February 21, 1997.

The Company's operations are interrelated with the operations of the Mutual Company, and various reinsurance arrangements exist between the Company and the Mutual Company. The Company believes that its various transactions with the Mutual Company have been on terms no less favorable to the Company than the terms that could have been negotiated with an independent third party.

The Mutual Company provides all personnel for the Company and its principal insurance subsidiaries, Atlantic States Insurance Company ("Atlantic States"), Delaware Atlantic Insurance Company, formerly known as Delaware American Insurance Company ("Delaware Atlantic"), and Southern Insurance Company of Virginia ("Southern"). Expenses are allocated to the Company, Delaware Atlantic and Southern according to a time allocation and estimated usage agreement, and to Atlantic States in relation to the relative participation of the Mutual Company and Atlantic States in the pooling agreement described herein. Such charges to the Company were $18,878,506 in 1996.

On December 29, 1988, the Company acquired all of the outstanding common stock of Southern, which converted from a mutual insurance company known as Southern Mutual Insurance Company to a stock insurance company on the same date. Since January 1, 1991, the Mutual Company has reinsured 50% of Southern's business. Because the Mutual Company places substantially all of the business assumed from Southern in the pool, from which the Company has an allocation which is 65% from and after January 1, 1996, the Company's operations include approximately 80% of the business written by Southern. Southern and the Mutual Company settle the balances resulting from this reinsurance arrangement on a monthly basis.

Atlantic States participates in an underwriting pool with the Mutual Company whereby Atlantic States cedes premiums, losses and loss adjustment expenses on all of its business to the Mutual Company and assumes from the Mutual Company a specified portion of the premiums, losses and loss adjustment expenses of the Mutual Company and Atlantic States. Under the pooling agreement, which became effective on October 1, 1986, Atlantic States cedes to the Mutual Company all of its insurance business written on or after October 1, 1986. Substantially all of the Mutual Company's property and casualty insurance business written or in force on or after October 1, 1986 is also included in the pooled business, including the business reinsured from Southern. Pursuant to an amendment to the pooling agreement effective October 1, 1988, the Mutual Company, which is solely responsible for any losses in the pooled business with dates of loss on or before the close of business on September 30, 1986, retroceded 50% of the pooled business to Atlantic States. From January 1, 1993 to December 31, 1995, 60% of the pooled business had been retroceded to Atlantic States. Since January 1, 1996, 65% of the pooled business was retroceded to Atlantic States. All premiums, losses, loss adjustment expenses and other underwriting expenses are prorated among the parties on the basis of their participation in the pool. The pooling agreement may be amended or terminated at the end of any calendar year by agreement of the parties. The allocations of pool participation percentages between the Mutual Company and the Company are based on the pool participants' relative amounts of capital and surplus, expectations of future relative amounts of capital and surplus and the ability of the Company to raise capital for Atlantic States. The Company does not currently anticipate a further increase in its percentage of participation in the pool, nor does the Company intend to terminate its participation in the pooling agreement. Additional information describing the pooling agreement is contained in the Company's 1996 Annual Report to Stockholders, a copy of which is enclosed with this Proxy Statement and to which reference is hereby made.

As of December 31, 1995, the Company acquired all of the outstanding capital stock of Delaware Atlantic pursuant to a Stock Purchase Agreement dated as of December 21, 1995 between the Company and the Mutual Company. As part of this transaction, the Mutual Company entered into an aggregate excess of loss reinsurance agreement with Delaware Atlantic whereby the Mutual Company insured the risk of any loss from an adverse development in Delaware Atlantic's loss and loss adjustment expense reserve at the end of 1995 compared to the end of 1996 and losses and loss

adjustment expenses incurred by Delaware Atlantic during the month of December 1995 and for the 1996 year by reason of the fact that Delaware Atlantic's loss and loss adjustment expense ratio for those periods exceeded the lesser of the loss and loss expense ratios of immediately preceding periods or 60%. This reinsurance agreement did not result in any additional payment from the Mutual Company to Delaware Atlantic.

Effective July 1, 1996, the Mutual Company entered into Retrocessional Reinsurance Contracts with each of Southern, Delaware Atlantic and Pioneer Insurance Company, a wholly owned subsidiary of the Mutual Company, (individually, an "Affiliate"), whereby the Mutual Company agreed to indemnify each Affiliate in respect of 100% of the net liability that may accrue to such Affiliate from its insurance operations and retrocede 100% of the net liability back to each Affiliate, which the Affiliate assumes.

All of the Company's officers are officers of the Mutual Company, five of the Company's seven directors are directors of the Mutual Company and two of the Company's executive officers are directors of the Mutual Company. The Company and the Mutual Company maintain a Coordinating Committee, which consists of two outside directors from each of the Company and the Mutual Company, none of whom holds seats on both Boards, to review and evaluate the pooling agreement between the Company and the Mutual Company and to be responsible for matters involving actual or potential conflicts of interest between the Company and the Mutual Company. The decisions of the Coordinating Committee are binding on the Company and the Mutual Company. The Company's Coordinating Committee members must conclude that intercompany transactions are fair and equitable to the Company. The purpose of this provision is to protect the interests of the stockholders of the Company other than the Mutual Company. The Coordinating Committee met two times in 1996. The Company's members on the Coordinating Committee are Messrs. Bolinger and Finley. See "Election of Directors." The Mutual Company's members on the Coordinating Committee are John E. Hiestand and Dr. Charles A. Heisterkamp, III.

Mr. Hiestand, age 59, has been a director of the Mutual Company since 1983 and has been President of Hiestand Memorials, Inc., a manufacturer of cemetery monuments, since 1977.

Dr. Heisterkamp, age 64, has been a director of the Mutual Company since 1979 and has practiced as a surgeon in Lancaster, Pennsylvania for more than the past five years.

## ELECTION OF DIRECTORS

The Company's Board of Directors consists of seven members. Each director is elected for a three-year term and until his successor has been duly elected. The current three-year terms of the Company's directors expire in the years 1997, 1998 and 1999, respectively.

Two Class B directors are to be elected at the Annual Meeting. Unless otherwise instructed, the proxy holders will vote the proxies received by them for the election of the nominees named below, both of whom are currently directors of the Company. If a nominee becomes unavailable for any reason, it is intended that the proxies will be voted for a substitute nominee designated by the Board of Directors. The Board of Directors has no reason to believe the nominees named will be unable to serve if elected. Any vacancy occurring on the Board of Directors for any reason may be filled by a majority of the directors then in office until the expiration of the term of the class of directors in which the vacancy exists. The two nominees for Class B director receiving a plurality of the votes cast at the

Annual Meeting will be elected as directors. Shares held by brokers or nominees as to which voting instructions have not been received from the beneficial owner or person otherwise entitled to vote and as to which the broker or nominee does not have discretionary voting power, i.e., broker nonvotes, will be treated as not present and not entitled to vote for nominees for election as Class B directors. Abstentions from voting and broker nonvotes will have no effect on the election of directors since they will not represent votes cast at the Annual Meeting for the purpose of electing directors.

The names of the nominees for Class B directors and the Class A and Class C directors who will continue in office after the Annual Meeting until the expiration of their respective terms, together with certain information regarding them, are as follows:

NOMINEES FOR CLASS B DIRECTORS

| NAME | AGE | DIRECTOR SINCE | YEAR TERM WILL EXPIRE* |
|---|---|---|---|
| C. Edwin Ireland | 87 | 1986 | 2000 |
| Donald H. Nikolaus | 54 | 1986 | 2000 |

DIRECTORS CONTINUING IN OFFICE

CLASS C DIRECTORS

| NAME | AGE | DIRECTOR SINCE | YEAR TERM WILL EXPIRE |
|---|---|---|---|
| Thomas J. Finley, Jr | 76 | 1986 | 1998 |
| R. Richard Sherbahn | 68 | 1986 | 1998 |

CLASS A DIRECTORS

| NAME | AGE | DIRECTOR SINCE | YEAR TERM WILL EXPIRE |
|---|---|---|---|
| Robert S. Bolinger | 60 | 1986 | 1999 |
| Patricia A. Gilmartin | 57 | 1986 | 1999 |
| Philip H. Glatfelter, II | 67 | 1986 | 1999 |

- ------------------
*If elected at the Annual Meeting

Mr. Bolinger has been President and Chief Executive Officer of Susquehanna Bancshares, Inc. since 1982 and of Farmers First Bank since 1976. Mr. Bolinger is also a director of Susquehanna Bancshares, Inc.

Mr. Finley retired in 1985 as President and Chief Executive Officer of the Insurance Federation of Pennsylvania, a position he held for 18 years.

Mrs. Gilmartin has been an employee since 1969 of Donegal Insurance Agency, which has no affiliation with the Company except that Donegal Insurance Agency receives insurance commissions in the ordinary course of business from the Company's subsidiaries and affiliates in accordance with such subsidiaries' and affiliates' standard commission schedules and agency contracts. Mrs. Gilmartin has been a director of the Mutual Company since 1979.

Mr. Glatfelter retired in 1989 as a Vice President of Meridian Bank, a position he held for more than five years prior to his retirement. Mr. Glatfelter has been a director of the Mutual Company since 1981 and has been Vice Chairman of the Mutual Company since 1991.

Mr. Ireland is former Chairman of the Lancaster Industrial Development Authority. He retired from Hamilton Watch Company in 1970. Prior thereto, he was Vice President, Secretary and Treasurer of Hamilton Watch Company. Mr. Ireland has been a director of the Mutual Company since 1972 and Chairman of its Board of Directors since 1985. He has been Chairman of the Company's Board of Directors since 1986.

Mr. Nikolaus has been President of the Mutual Company since 1981 and a director of the Mutual Company since 1972. He has been President of the Company since 1986. Mr. Nikolaus has been a partner in the law firm of Nikolaus & Hohenadel since 1972.

Mr. Sherbahn has owned and operated Sherbahn Associates, Inc., a life insurance and financial planning firm, since 1974. Mr. Sherbahn has been a director of the Mutual Company since 1967.

## THE BOARD OF DIRECTORS AND ITS COMMITTEES

The Board of Directors met five times in 1996. The Board of Directors has an Executive Committee, an Audit Committee, a Nominating Committee, a Compensation Committee and, together with the Mutual Company, a four-member Coordinating Committee.

The Company's Executive Committee met 20 times in 1996. Messrs. Nikolaus, Ireland and Glatfelter are the members of the Executive Committee. The Executive Committee has the authority to take all action that can be taken by the full Board of Directors, consistent with Delaware law, between Board of Directors' meetings.

The Audit Committee of the Company consists of Messrs. Bolinger, Glatfelter and Ireland. The Audit Committee, which met one time in 1996, reviews audit reports and management recommendations made by the Company's outside auditing firm.

The Nominating Committee of the Company consists of Messrs. Finley, Ireland and Glatfelter. The Nominating Committee, which did not meet in 1996, is responsible for the nomination of candidates to stand for election to the Board of Directors at the Annual Meeting and the nomination of candidates to fill vacancies on the Board of Directors between meetings of stockholders. The Nominating Committee will consider written nominations for directors from stockholders to the extent such nominations are made in accordance with the Company's By-laws. The Company's By-laws require that any such nominations must be sent to the Company at its principal executive offices, attention: Secretary, not less than 30 days prior to the date of the stockholders meeting at which directors are to be elected. Such written nomination must set forth the name, age, address and principal occupation for the past five years of such nominee, the number of shares of the Company's Common Stock beneficially owned by such nominee and such other information about such nominee as would be required under the proxy solicitation rules of the SEC if proxies were solicited for the election of such nominee.

The Compensation Committee of the Company consists of Messrs. Ireland, Sherbahn and Glatfelter. The Compensation Committee met two times in 1996 to review and recommend compensation plans, approve certain compensation changes and grant options under and determine participants in the Equity Incentive Plan.

COMPENSATION OF DIRECTORS

Directors of the Company were paid an annual retainer of $14,000 in 1996 and were paid $500 for each meeting attended in excess of five per year. Directors who are members of committees of the Board of Directors receive $250 for each committee meeting attended. If a director serves on the Board of Directors of both the Mutual Company and the Company, the director receives only one annual retainer. If the Boards of Directors of both companies meet on the same day, directors receive only one meeting fee. In such event, the retainer and meeting fees are allocated 35% to the Mutual Company and 65% to the Company.

Pursuant to the 1996 Director Plan, each director of the Company and the Mutual Company will receive annually restricted stock awards ("Restricted Stock Awards") of 100 shares of the Company's Common Stock, provided that the director served as a member of the Board of Directors of the Company or the Mutual Company during any portion of the preceding calendar year, and each outside director of the Company and the Mutual Company is eligible to receive non-qualified stock options to purchase shares of Common Stock in an amount to be determined by the Company's Board of Directors. In furtherance of the 1996 Director Plan, on January 2, 1997, each director of the Company and the Mutual Company was granted a Restricted Stock Award of 100 shares of Common Stock and each outside director of the Company and the Mutual Company was granted non-qualified options to purchase 5,000 shares of Common Stock, subject to adoption of the 1996 Director Plan by the Company's stockholders at the Annual Meeting. The exercise price of each option granted under the 1996 Director Plan was in excess of the fair market value of a share of the Company's Common Stock on the date that the options were granted. See "Adoption of the 1996 Equity Incentive Plan for Directors."

## EXECUTIVE COMPENSATION

### SUMMARY COMPENSATION TABLE

The following table sets forth the compensation paid by the Company and the Mutual Company during each of the three fiscal years ended December 31, 1996 for services rendered in all capacities to the chief executive officer of the Company and the four other most highly compensated executive officers of the Company whose compensation exceeded $100,000 in the fiscal year ended December 31, 1996.

| | | ANNUAL COMPENSATION (1) | | | LONG-TERM COMPENSATION | | |
|---|---|---|---|---|---|---|---|
| | | | | | AWARDS | | |
| NAME AND PRINCIPAL POSITION | YEAR | SALARY ($) | BONUS ($) | OTHER ANNUAL COMPENSATION ($) | RESTRICTED STOCK AWARDS ($) | SECURITIES UNDERLYING OPTIONS (#) | ALL OTHER COMPENSATION ($)(3) |
| Donald H. Nikolaus, | 1996 | $ 336,000 | $ 0 | $ 7,327 | -- | -- | $ 81,531(2) |
| President and Chief | 1995 | 311,000 | 100,369 | 0 | -- | -- | 85,430 |
| Executive Officer | 1994 | 281,000 | 0 | 0 | -- | -- | 64,776 |
| Ralph G. Spontak, | 1996 | 220,000 | 0 | 2,747 | -- | -- | 44,495(2) |
| Senior Vice President, | 1995 | 204,000 | 57,133 | 0 | -- | -- | 46,205 |
| Chief Financial Officer and Secretary | 1994 | 184,000 | 0 | 0 | -- | -- | 34,496 |
| William H. Shupert, | 1996 | 149,000 | 0 | 0 | -- | -- | 28,669(2) |
| Senior Vice President, | 1995 | 137,000 | 47,868 | 0 | -- | -- | 22,791 |
| Underwriting | 1994 | 122,000 | 0 | 0 | -- | -- | 19,244 |
| Frank J. Wood | 1996 | 102,500 | 0 | 0 | -- | -- | 15,713(2) |
| Vice President, | 1995 | 95,000 | 18,530 | 0 | -- | -- | 13,576 |
| Marketing | 1994 | 86,500 | 0 | 0 | -- | -- | 16,424 |
| Robert G. Shenk | 1996 | 118,000 | 0 | 0 | -- | -- | 13,614(2) |
| Vice President, | 1995 | 107,000 | 15,966 | 0 | -- | -- | 13,001 |
| Claims | 1994 | 96,000 | 0 | 0 | -- | -- | 12,415 |

(1) All compensation of officers of the Company is paid by the Mutual Company. Pursuant to the terms of an intercompany allocation agreement between the Company and the Mutual Company, the Company is charged for its proportionate share of all such compensation.

(2) Represents contributions made by the Company under its defined contribution pension plan of $14,140 for Mr. Nikolaus, $14,140 for Mr. Spontak, $14,040 for Mr. Shupert, $10,940 for Mr. Shenk and $11,190 for Mr. Wood and contributions made by the Company under its profit-sharing plan of $3,163 for Mr. Nikolaus, $3,163 for Mr. Spontak, $2,876 for Mr. Shupert, $2,244 for Mr. Shenk and $1,996 for Mr. Wood. In the case of Mr. Nikolaus, the total shown for 1996 also includes premiums paid under split-dollar life insurance policies of $23,276, premiums paid under a term life insurance policy of $2,448, directors and committee meeting fees of $20,000 and contributions made by the Company of $18,504 under the Company's Executive Restoration Plan, which is designed to restore certain retirement benefits to those individuals for whom contributions to the Company's pension and profit-sharing plans are restricted as a result of the application of Sections 401(a)(17) and 415 of the Internal Revenue Code. In the case of Mr. Spontak, the total shown for 1996 includes premiums paid under a split-dollar life insurance policy of $4,363, premiums paid under a term life insurance policy of $891, directors and committee meeting fees of $15,000 and contributions made by the Company of $6,938 under the Company's Executive Restoration Plan. In the case of Messrs. Shupert, Shenk and Wood, the totals shown for 1996 also include term life insurance premiums of $11,753, $430 and $2,527, respectively.

No options were granted by the Company during the year ended December 31, 1996 to any of the persons named in the Summary Compensation Table.

The following table sets forth information with respect to options exercised during the year ended December 31, 1996 and held on December 31, 1996 by the persons named in the Summary Compensation Table.

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR
AND FISCAL YEAR END OPTION VALUES

| NAME | SHARES ACQUIRED ON EXERCISE | VALUE REALIZED | NUMBER OF SECURITIES UNDERLYING OPTIONS AT FISCAL YEAR END | | VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT FISCAL YEAR END | |
|---|---|---|---|---|---|---|
| | | | EXERCISABLE | UNEXERCISABLE | EXERCISABLE | UNEXERCISABLE |
| Donald H. Nikolaus..... | 65,000 | $ 382,500 | -- | -- | $ -- | $ -- |
| Ralph G. Spontak..... | 53,000 | 365,700 | -- | -- | -- | -- |
| William H. Shupert..... | -- | -- | -- | -- | -- | -- |
| Frank J. Wood..... | 10,000 | 53,750 | -- | -- | -- | -- |
| Robert Shenk..... | 10,000 | 61,875 | -- | -- | -- | -- |

REPORT OF THE COMPENSATION COMMITTEE OF DONEGAL GROUP INC.

THE FOLLOWING REPORT OF THE COMPANY'S COMPENSATION COMMITTEE AND THE PERFORMANCE GRAPH THAT IMMEDIATELY FOLLOWS SUCH REPORT SHALL NOT BE DEEMED PROXY SOLICITATION MATERIAL, SHALL NOT BE DEEMED FILED WITH THE SEC UNDER THE EXCHANGE ACT OR INCORPORATED BY REFERENCE IN ANY DOCUMENT SO FILED AND SHALL NOT OTHERWISE BE SUBJECT TO THE LIABILITIES OF SECTION 18 OF THE EXCHANGE ACT.

Under rules established by the SEC, the Company is required to provide certain information about the compensation and benefits provided to the Company's President and Chief Executive Officer and the other executive officers listed in the Summary Compensation Table. The disclosure requirements as to these officers include the use of specified tables and a report of the Company's Compensation Committee reviewing the factors that resulted in compensation decisions affecting these officers and the Company's other executive officers. The Compensation Committee of the Board of Directors has furnished the following report in fulfillment of the SEC's requirements.

The Compensation Committee reviews the general compensation policies of the Company, including the compensation plans and compensation levels for executive officers, and administers the Company's 1996 Equity Incentive Plan and the cash incentive compensation program in which the Company's executive officers participate. No members of the Compensation Committee are former or current officers of the Company, or have other interlocking relationships as defined by the SEC.

Compensation of the Company's executive officers has two principal elements: (i) an annual portion, consisting of a base salary that is reviewed annually and cash bonuses based on the Company's underwriting results, and (ii) a long-term portion, consisting of stock options. In general, the executive compensation program of the Company has been designed to:

(i) Attract and retain executive officers who contribute to the long-term success of the Company;

(ii) Motivate key senior executive officers to achieve strategic business objectives and reward them for the achievement of these objectives; and

(iii) Support a compensation policy that differentiates in compensation amounts based on corporate and individual performance and responsibilities.

A major component of the Company's compensation policy, which has been approved by the Compensation Committee, is that a significant portion of the aggregate annual compensation of the Company's executive officers should be based upon the Company's underwriting results as well as the contribution of the individual officer. For a number of years, the Company has maintained a cash incentive compensation program for the Company's executive officers. This program provides a formula pursuant to which a fixed percentage of the Company's underwriting results for the year is computed, as specified in the program, and then allocated among the executive officers selected to participate in the program for the particular year. The identity of the executive officers selected to participate in the program for the particular year as well as their participation in the amount determined by application of the fixed formula is based upon recommendations submitted by the Company's senior executive officers to the Compensation Committee. The Compensation Committee reviews those recommendations and fixes the percentage participation of the Company's executive officers in the program. The portion of the total compensation of the executive officers named in the Summary Compensation Table arising from the cash incentive compensation program formula was zero in 1996 compared to the indicated bonuses paid in 1995 because the Company's underwriting income in 1996 was substantially less than its underwriting income in 1995 as a result of losses caused by the severe winter storms during the first quarter of 1996. The Compensation Committee therefore believes that the amount of the incentive payments are tied directly to the Company's performance.

The principal factors considered by the Company when it established the cash incentive compensation program were:

(i) achievement of the Company's long-term underwriting objectives; and

(ii) the Company's long-term underwriting results compared to the long-term underwriting results of other property and casualty insurance companies.

Such factors as continued cost control and reductions in the Company's expense ratio, enhancement of the skills of the Company's workforce, the development of opportunities to expand the geographic reach of the Company's service area on a profitable basis and the commencement of a construction program to increase the efficiency of the Company's operations as well as a subjective analysis of Mr. Nikolaus' performance were considered by the Committee in establishing the compensation of Mr. Nikolaus for 1996. Mr. Nikolaus did not receive any award for 1996 under the Company's cash incentive compensation program because of the losses the Company incurred in the first quarter of 1996 as the result of severe winter weather.

The Company's executive officers participate in the Company's 1996 Equity Incentive Plan, under which stock options are granted from time to time at the fair market value of the Company's Common Stock on the date of grant. The options typically vest over three years. The primary purpose of the 1996 Equity Incentive Plan is to provide an incentive for the Company's long-term performance. Such stock options provide an incentive for the creation of stockholder value over the long-term because the full benefit of the options can be realized only if the price of the Company's Common Stock appreciates over time. No stock options were granted to the Company's executive officers under the 1996 Equity Incentive Plan during 1996.

The Compensation Committee believes the compensation of Mr. Nikolaus and the other executive officers of the Company is reasonable in view of the Company's performance and the contribution of those officers to that performance in 1996, as well as the performance of the Company in 1996 compared to the performance of other property and casualty insurance companies in 1996.

Section 162(m) of the Internal Revenue Code, applicable for 1994 and subsequent years, generally disallows a tax deduction to publicly held companies for compensation of more than $1 million paid to the company's chief executive officer or any executive officer named in its Summary Compensation Table. Qualifying performance-based compensation will not be subject to the deduction limit if certain requirements are met. The policy of the Compensation Committee is to structure the compensation of the Company's executive officers, including Mr. Nikolaus, to avoid the loss of the deductibility of any compensation, although Section 162(m) will not preclude the Compensation Committee from awarding compensation in excess of $1 million, if it should be warranted in the future. The Company believes that Section 162(m) will not have any effect on the deductibility of the compensation of Mr. Nikolaus and the other executive officers named in the Summary Compensation Table for 1996.

DONEGAL GROUP INC. COMPENSATION COMMITTEE

C. Edwin Ireland
R. Richard Sherbahn
Philip H. Glatfelter, II

COMPARISON OF TOTAL RETURN ON THE COMPANY'S COMMON STOCK WITH CERTAIN AVERAGES

The following graph provides an indicator of cumulative total stockholder returns on the Company's Common Stock compared to the Russell 2000 Index and a peer group of property and casualty insurance companies selected by Value Line, Inc. The members of the peer group are as follows: 20th Century Industries, W.R. Berkley Corporation, The Chubb Corporation, Cincinnati Financial Corporation, USF&G Corporation, Fremont General Corporation, Frontier Insurance Group, Inc., Gainsco Inc., General Reinsurance Corporation, The Hartford Steam Boiler Inspection and Insurance Company, Orion Capital Corporation, Ohio Casualty Corporation, The Progressive Corporation, SAFECO Corporation, Selective Insurance Group, Inc. and The St. Paul Companies, Inc.

COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN*
Donegal Group, Russell 2000 Index and Value Line Insurance: Property/Casualty Index
(Performance Results Through 12/31/96)


[GRAPHIC]

In the printed version there appears a line graph depiciting the following plot points:

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|
| Donegal Group | $100.00 | $112.07 | $180.17 | $157.35 | $208.58 | $233.51 |
| Russell 2000 Index | $100.00 | $118.41 | $140.80 | $138.01 | $177.26 | $206.48 |
| Insurance: Prop/Cas | $100.00 | $125.15 | $123.81 | $124.60 | $165.24 | $183.72 |

Assumes $100 invested at the close of trading 12/91 in Donegal Group Inc. Common Stock, Russell 2000 Index and Insurance Property/Casualty.

*Cumulative total return assumes reinvestment of dividends.

## CERTAIN TRANSACTIONS

Donald H. Nikolaus, President and a director of the Company and the Mutual Company, is also a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as general counsel to the Mutual Company since 1970 and to the Company since 1986, principally in connection with the defense of claims litigation arising in Lancaster, Dauphin and York counties. Such firm is paid its customary fees for such services.

Patricia A. Gilmartin, a director of the Company and the Mutual Company, is an employee of Donegal Insurance Agency, which has no affiliation with the Company except that Donegal Insurance Agency receives insurance commissions in the ordinary course of business from the Company's subsidiaries and affiliates in accordance with such subsidiaries' and affiliates' standard commission schedules and agency contracts.

Frederick W. Dreher, a director of the Mutual Company, is a partner in the law firm of Duane, Morris & Heckscher, which represents the Company in numerous legal matters. Such firm is paid its customary fees for such services.

During 1996, certain executive officers of the Company exercised options held by them pursuant to the Company's 1986 Equity Incentive Plan and thereafter sold the shares of the Company's Common Stock thereby acquired to the Mutual Company. In each case, the price paid was the closing bid price of the Company's Common Stock on May 3, 1996, three days prior to the date of the sale. From the sale proceeds, the Mutual Company paid the exercise price of the options exercised to the Company, made the appropriate withholding deduction for income tax purposes and remitted the remaining balance to the selling executive officer. Certain information concerning these transactions is as follows:

| NAME OF SELLER | NUMBER OF SHARES SOLD | NET PROCEEDS RECEIVED |
|---|---|---|
| Donald H. Nikolaus | 60,000 | $331,250 |
| Ralph G. Spontak | 50,000 | $335,000 |

## APPROVAL OF THE ELECTION OF INDEPENDENT PUBLIC ACCOUNTANTS

Unless instructed to the contrary, it is intended that votes will be cast pursuant to the proxies for the election of KPMG Peat Marwick LLP as the Company's independent public accountants for 1997. The Company has been advised by KPMG Peat Marwick LLP that none of its members has any financial interest in the Company. Election of KPMG Peat Marwick LLP will require the affirmative vote of a majority of the shares of Common Stock represented in person or by proxy at the Annual Meeting.

A representative of KPMG Peat Marwick LLP will attend the Annual Meeting, will have the opportunity to make a statement, if he desires to do so, and will be available to respond to any appropriate questions presented by stockholders at the Annual Meeting.

## ADOPTION OF AMENDED AND RESTATED 1996 EQUITY INCENTIVE PLAN

The Board of Directors amended the 1996 Equity Incentive Plan and approved an Amended and Restated 1996 Equity Incentive Plan on December 19, 1996, subject to stockholder approval at the Annual Meeting, to: (i) increase the total number of shares for which grants may be made to 695,850 shares, in order to make additional shares available under the 1996 Equity Incentive Plan in the future for officers and key employees, (ii) limit to 100,000 shares the total number of shares of Common Stock for which stock options (the "Options") to purchase Common Stock of the Company may be granted to any employee in any calendar year and (iii) make other non-material changes with respect to the administration of the 1996 Equity Incentive Plan. If the Amended and Restated 1996 Equity Incentive Plan is not approved by the stockholders at the Annual Meeting, the 1996 Equity Incentive Plan will remain in force in its current form. However, because the Mutual Company will vote for approval of the Amended and Restated 1996 Equity Incentive Plan, the Amended and Restated 1996 Equity Incentive Plan will be approved regardless of the votes of the Company's stockholders other than the Mutual Company.

The purpose of the 1996 Equity Incentive Plan is to further the growth, development and financial success of the Company, the Mutual Company and the subsidiaries of the Company and the Mutual Company by providing additional incentives to those officers and key employees who are responsible for the management and affairs of the Company, the Mutual Company and the subsidiaries of the Company and the Mutual Company, which will enable them to participate in any increase in value of the Common Stock of the Company.

The 1996 Equity Incentive Plan permits the granting of Options, including Options intended to qualify as incentive stock options under the Internal Revenue Code ("Incentive Stock Options") and Options not intended to so qualify ("Non-Qualified Options") to those officers and key employees of the Company, the Mutual Company and the subsidiaries of the Company and the Mutual Company who are in positions in which their decisions, actions and counsel significantly impact upon the profitability and success of the Company, the Mutual Company and the subsidiaries of the Company and the Mutual Company. Directors of the Company who are not also officers or employees of the Company, the Mutual Company or the subsidiaries of the Company and the Mutual Company are not eligible to participate in the 1996 Equity Incentive Plan. Nothing contained in the 1996 Equity Incentive Plan affects the right of the Company, the Mutual Company or any subsidiary of the Company or the Mutual Company to terminate the employment of any employee.

The total number of shares of Common Stock that may be the subject of Options granted under the 1996 Equity Incentive Plan may not currently exceed 345,850 shares in the aggregate. As of February 1, 1997 Options for the purchase of an aggregate of 299,500 shares were outstanding. Therefore, a total of only 46,350 shares of Common Stock are currently available for grants under the 1996 Equity Incentive Plan.

The amendment will increase the number of shares currently available for grants under the 1996 Equity Incentive Plan in furtherance of the purposes of the plan for the next several years. No determination has been made as to the allocation of grants with respect to the additional shares to specific employees. The Company believes that the additional shares will be required to satisfy anticipated annual Option grants over the next several years.

The number of persons who are eligible to participate in the 1996 Equity Incentive Plan is approximately 345, including executive officers of the Company, the Mutual Company and the subsidiaries of the Company and the Mutual Company. Through February 21, 1997: (i) Non-Qualified Options to purchase an aggregate of 167,500 shares were granted to executive officers of the Company, which included the following: Mr. Nikolaus, 60,000 shares; Mr. Spontak, 30,000 shares; Mr. Shupert, 18,000 shares; Mr. Wood, 13,500 shares and Mr. Shenk, 13,500 shares and (ii) Incentive Stock Options to purchase an aggregate of 31,000 shares were granted to executive officers of the Company, which included the following: Mr. Nikolaus, 15,000 shares; Mr. Spontak, 7,500 shares; Mr. Shupert, 3,000 shares; Mr. Wood, 1,500 shares and Mr. Shenk, 15,000 shares.

On March 3, 1997, the closing price of the Company's Common Stock as reported on the Nasdaq National Market was $24.50 per share.

No Options may be granted under the 1996 Equity Incentive Plan after February 15, 2006. If an Option expires or is terminated for any reason without having been fully exercised, the number of shares subject to such Option which have not been purchased may again be made subject to an Option under the 1996 Equity Incentive Plan. Appropriate adjustments to outstanding Options and to the number or kind of shares subject to the 1996 Equity Incentive Plan are provided for in the event of a stock split, reverse stock split, stock dividend, share combination or reclassification and certain other types of corporate transactions involving the Company, including a merger or a sale of substantially all of the assets of the Company. As amended, the maximum number of shares of Common Stock for which Options may be granted under the 1996 Equity Incentive Plan to any officer or employee in any calendar year is 100,000 shares.

As amended, the 1996 Equity Incentive Plan may be administered by the Board of Directors of the Company or a committee of two or more members, each of whom must be a "non-employee director" within the meaning of rule 16b-3 under the Exchange Act (the "Committee"), and is currently administered by the Compensation Committee of the Board of Directors, consisting of Messrs. Ireland, Sherbahn and Glatfelter. See "Election of Directors -- Meetings and Committees of the Board." The Committee is authorized to (i) interpret the provisions of the 1996 Equity Incentive Plan and decide all questions of fact arising in its application; (ii) select the employees to whom Options are granted and determine the timing, type, amount, size and terms of each such grant and (iii) to make all other determinations necessary or advisable for the administration of the 1996 Equity Incentive Plan.

INCENTIVE AND NON-QUALIFIED OPTIONS

The exercise price of shares subject to Options granted under the 1996 Equity Incentive Plan will be set by the Committee but may not be less than 100% of the fair market value per share of Common Stock on the date the Option is granted as determined by the Committee.

Options will be evidenced by written agreements in such form not inconsistent with the 1996 Equity Incentive Plan as the Committee shall approve from time to time. Each agreement will state the period or periods of time within which the Option may be exercised. The Committee may accelerate the exercisability of any Option upon such circumstances and subject to such terms and conditions as the Committee deems appropriate. Unless the Committee accelerates exercisability, no Option that is unexercisable at the time of the optionee's termination of employment may thereafter become exercisable. No Option may be exercised after ten years from the date of grant.

An outstanding Non-Qualified Option that has become exercisable generally terminates one year after the termination of employment due to death, retirement or total disability and three months after employment termination for any reason other than retirement, total disability or death. Incentive Stock Options that have become exercisable generally will terminate one year after termination of employment due to total disability or death and three months after an employment termination for any other reason. No Option may be assigned or transferred, except by will or by the applicable laws of descent and distribution. During the lifetime of the optionee, an Option may be exercised only by the optionee.

The Committee will determine whether Options granted are to be Incentive Stock Options meeting the requirements of Section 422 of the Code. Incentive Stock Options may be granted only to eligible employees. Any such optionee must own less than 10% of the total combined voting power of the Company or of any of its subsidiaries unless at the time such Incentive Stock Option is granted the option price is at least 110% of the fair market value of the Common Stock subject to the Option and, by its terms, the Incentive Stock Option is not exercisable after the expiration of five years from the date of grant. An optionee may not receive Incentive Stock Options for shares that first become exercisable in any calendar year with an aggregate fair market value determined at the date of grant in excess of $100,000.

The option price must be paid in full at the time of exercise unless otherwise determined by the Committee. Payment must be made in cash, in shares of Common Stock valued at their then fair market value, or a combination thereof, as determined in the discretion of the Committee. It is the policy of the Committee that any taxes required to be withheld must also be paid at the time of exercise. The Committee may, in its discretion, allow an optionee to enter into an agreement with the Company's transfer agent or a brokerage firm of national standing whereby the optionee will simultaneously exercise the Option and sell the shares acquired thereby and either the Company's transfer agent or the brokerage firm executing the sale will remit to the Company from the proceeds of sale the exercise price of the shares as to which the Option has been exercised.

AMENDMENT AND TERMINATION

The Committee may terminate or amend the 1996 Equity Incentive Plan at any time with respect to shares as to which Options have not been granted, subject to any required stockholder approval or any stockholder approval that the Board may deem to be advisable for any reason, such as for the purpose of obtaining or retaining any statutory or regulatory benefits under tax, securities or other laws or satisfying any applicable stock exchange listing requirements. No modification, amendment or termination may be made to the 1996 Equity Incentive Plan, without the consent of an optionee, if such modification, amendment or termination will affect the rights of the optionee under an Option previously granted.

FEDERAL INCOME TAX CONSEQUENCES

The 1996 Equity Incentive Plan is not a qualified plan under Section 401(a) of the Code. The following description, which is based on existing laws, sets forth generally certain of the federal income tax consequences of the Options under the 1996 Equity Incentive Plan. This description may differ from the actual tax consequences of participation in the 1996 Equity Incentive Plan.

An employee receiving an Option will not recognize taxable income upon the grant of the Option, nor will the Company be entitled to any deduction on account of such grant. In the case of Non-Qualified Stock Options, the employee will recognize ordinary income upon the exercise of the Non-Qualified Stock Option in an amount equal to the difference between the option price and the fair market value of the shares on the date of exercise. When the employee disposes of the shares acquired upon exercise of the Option, the employee will generally recognize capital gain or loss equal to the difference between (i) the selling price of the shares and (ii) the sum of the option price and the amount included in his or her income when the Option was exercised. Such gain will be long-term or short-term depending upon whether the shares were held for at least one year after the date of exercise.

Incentive Stock Options granted under the 1996 Equity Incentive Plan are intended to qualify as incentive stock options under Section 422 of the Code. A purchase of shares upon exercise of an Incentive Stock Option will not result in recognition of income at that time. However, the excess of the fair market value of the shares purchased over the exercise price will constitute an item of tax preference. This tax preference will be included in the employee's computation of the employee's alternative minimum tax.

If the optionee does not dispose of the shares issued to the optionee upon the exercise of an Incentive Stock Option within one year of such issuance or within two years from the date of the grant of such Option, whichever is later, then any gain or loss realized by the optionee on a later sale or exchange of such shares generally will be a long-term capital gain or a long-term capital loss. If the optionee sells the shares during such period, the sale will be deemed a "disqualifying disposition." In that event, the optionee will recognize ordinary income for the year in which the disqualifying disposition occurs equal to the amount, if any, by which the lesser of the fair market value of such shares on the date of exercise of such Option or the amount realized from the sale exceeded the amount the optionee paid for such shares. Any additional gain realized generally will be capital gain, which will be long-term or short-term depending on the holding period for the shares. If the optionee disposes of the shares by gift during such period, the transfer will be treated as a disqualifying disposition subject to the rules described herein.

If the purchase price upon exercise of an Option is paid with shares already owned by the optionee, generally no gain or loss will be recognized with respect to the shares used for payment and the additional shares received will be taxed as described herein. However, if payment of the purchase price upon exercise of an Incentive Stock Option is made with shares acquired upon exercise of an Incentive Stock Option before the shares used for payment have been held for the two-year or one-year period described herein, use of such shares as payment will be deemed a "disqualifying disposition" of the shares used for payment subject to the rules described herein.

Under current law, any gain realized by an optionee, other than long-term capital gain, is taxable at a maximum federal income tax rate of 39.6%. Long-term capital gain is taxable at a maximum federal income tax rate of 28%.

The Company will be entitled to a tax deduction in connection with an Option under the 1996 Equity Incentive Plan in an amount equal to the ordinary income realized by the optionee and at the time such optionee recognizes such income. The federal, state and local income tax consequences to any particular taxpayer will depend upon the taxpayer's individual circumstances. In addition, various tax legislative proposals are introduced in the Congress from time to time, and it is not possible to predict which of the various proposals introduced will be enacted into law, the form in which they

finally may be enacted, the effective dates thereof or the effect on the tax consequences of participation in the 1996 Equity Incentive Plan.

VOTE REQUIRED

Adoption of the Amended and Restated 1996 Equity Incentive Plan will require the affirmative vote of the holders of a majority of the outstanding shares of the Company's Common Stock present in person or represented by proxy at the Annual Meeting and entitled to vote. Abstentions are considered shares of stock present in person or represented by proxy at the meeting and entitled to vote and are counted in determining the number of votes necessary for a majority. An abstention therefore will have the practical effect of voting against adoption of the Amended and Restated 1996 Equity Incentive Plan because it represents one fewer vote for adoption of the Amended and Restated 1996 Equity Incentive Plan. Broker non-votes are not considered shares present in person or represented by proxy and entitled to vote on the Amended and Restated 1996 Equity Incentive Plan and will have no effect on the vote. The Board of Directors recommends that the stockholders vote FOR the adoption of the Amended and Restated 1996 Equity Incentive Plan.

## ADOPTION OF THE 1996 EQUITY INCENTIVE PLAN FOR DIRECTORS

DESCRIPTION OF THE 1996 DIRECTOR PLAN

The Board of Directors of the Company (the "Board") adopted the 1996 Director Plan on December 19, 1996, subject to stockholder approval at the Annual Meeting. The purpose of the 1996 Director Plan is to enhance the ability of the Company and the Mutual Company to attract and retain highly qualified directors, to compensate them for their services to the Company and the Mutual Company, as the case may be, and, in so doing, to strengthen the alignment of the interests of the directors with the interests of the stockholders by ensuring ongoing ownership of the Company's Common Stock.

The 1996 Director Plan provides for: (i) the grant of non-qualified options ("Director Options") to outside directors (an "Outside Director") of the Company and the Mutual Company and (ii) an annual grant to each director of the Company and the Mutual Company (a "Director") of a restricted stock award (a "Restricted Stock Award") of 100 shares of Common Stock to be issued on the first business day of January in each year, commencing January 2, 1997, provided that the Director served as a member of the Board or the Board of Directors of the Mutual Company during any portion of the prior year. Director Options and Restricted Stock Awards collectively are hereinafter referred to as "Stock Rights." Restricted Stock Awards are made automatically, and no action by the Board or the Board of Directors of the Mutual Company will be required. The number of shares of Common Stock that may be the subject of grants under the 1996 Director Plan may not exceed 90,000 shares in the aggregate.

The number of persons who are eligible to participate in the 1996 Director Plan is currently 12, consisting of directors of the Company and the Mutual Company. As of March 1, 1997, Director Options to purchase 45,000 shares of Common Stock, in the aggregate, have been granted to Outside Directors and Restricted Stock Awards of 1,200 shares, in the aggregate, have been granted to the Directors under the 1996 Director Plan. The issuance of Stock Rights is subject to approval of the 1996 Director Plan by the stockholders of the Company at the Annual Meeting.

Appropriate adjustments to outstanding Options and to the number or kind of shares subject to the 1996 Director Plan are provided for in the event of a stock split, reverse stock split, stock dividend, share combination or reclassification and certain other types of corporate transactions involving the Company, including a merger or a sale of substantially all of the assets of the Company.

The 1996 Director Plan is administered by the Board. The Board has the power to interpret the 1996 Director Plan, the Director Options and the Restricted Stock Awards, and, subject to the terms of the 1996 Director Plan, to determine who will be granted Director Options, the number of Director Options to be granted to any Outside Director, the timing of such grant and the terms of exercise. The Board also has the power to adopt rules for the administration, interpretation and application of the 1996 Director Plan. The Board does not have any discretion to determine who will be granted Restricted Stock Awards under the 1996 Director Plan, to determine the number of Restricted Stock Awards to be granted to each Director or to determine the timing of such grants.

RESTRICTED STOCK AWARDS

Restricted Stock Awards consist of shares of Common Stock that are issued in the name of the Director but that may not be sold or otherwise transferred by the grantee until one year after the date of grant. Upon the issuance of shares under a Restricted Stock Award, the Director will have all rights of a stockholder with respect to the shares, except that such shares may not be sold, transferred or otherwise disposed of until one year after the date of grant.

Restricted Stock Awards will be evidenced by written agreements in such form not inconsistent with the 1996 Director Plan as the Board shall approve from time to time. Each agreement shall contain such restrictions, terms and conditions as are required by the 1996 Director Plan. Although the Common Stock comprising each Restricted Stock Award will be registered in the name of the grantee, a restrictive legend shall be placed on the stock certificate.

NON-QUALIFIED STOCK OPTIONS

The exercise price of Director Options granted under the 1996 Director Plan will be set by the Board and may not be less than 100% of the fair market value per share of the Common Stock on the date that the Director Option is granted.

Director Options will be evidenced by written agreements in such form not inconsistent with the 1996 Director Plan as the Board shall approve from time to time. Each agreement will state the period or periods of time within which the Director Option may be exercised. The Board may accelerate the exercisability of any Director Options upon such circumstances and subject to such terms and conditions as the Board deems appropriate. Unless the Board accelerates exercisability, no Director Option that is unexercisable at the time of the optionee's termination of service as a Director may thereafter become exercisable. No Director Option may be exercised after ten years from the date of grant. If a Director Option expires or is canceled for any reason without having been fully exercised or vested, the number of shares subject to such Director Option that had not been purchased or become vested may again be made subject to a Director Option under the 1996 Director Plan.

The option price must be paid in full at the time of exercise unless otherwise determined by the Board. Payment must be made in cash, in shares of Common Stock valued at their then fair market value, or a combination thereof, as determined in the discretion of the Board. It is the policy of the Board that any taxes required to be withheld must also be paid at the time of exercise. The Board may,

in its discretion, allow an optionee to enter into an agreement with the Company's transfer agent or a brokerage firm of national standing whereby the optionee will simultaneously exercise the Director Option and sell the shares acquired thereby and either the Company's transfer agent or the brokerage firm executing the sale will remit to the Company from the proceeds of sale the exercise price of the shares as to which the Director Option has been exercised as well as the required amount of withholding.

An outstanding Director Option that has become exercisable generally terminates one year after termination of a Director's service as a Director due to death and three months after termination of a Director's service as a Director for any reason other than death. A Director Option granted under the 1996 Director Plan may be exercised during the lifetime of the optionee only by the optionee.

AMENDMENT OR TERMINATION

The 1996 Director Plan will remain in effect until all Director Options granted under the 1996 Director Plan have been satisfied by the issuance of shares, except that no Stock Rights may be granted under the 1996 Director Plan after December 19, 2006. The Board may terminate, modify, suspend or amend the 1996 Director Plan at any time, subject to any required stockholder approval or any stockholder approval that the Board may deem to be advisable for any reason, such as for the purpose of obtaining or retaining any statutory or regulatory benefits under tax, securities or other laws or satisfying any applicable stock exchange listing requirements. No modification, amendment or termination to the 1996 Director Plan will alter or impair any rights or obligations under any outstanding Stock Right without the consent of the optionee or grantee, as the case may be. No Stock Right may be granted during any period of suspension nor after termination of the 1996 Director Plan.

FEDERAL INCOME TAX CONSEQUENCES

The 1996 Director Plan is not a qualified plan under Section 401(a) of the Code. The following description, which is based on existing laws, sets forth generally certain of the federal income tax consequences of Stock Rights granted under the 1996 Director Plan. This description may differ from the actual tax consequences of participation in the 1996 Director Plan.

An optionee will not recognize income for federal income tax purposes upon the receipt of a Director Option, nor will the Company be entitled to any deduction on account of such grant. Such optionee will recognize ordinary taxable income for federal income tax purposes at the time of exercise in the amount by which the fair market value of such shares then exceeds the option price. When the optionee disposes of the shares acquired upon exercise of the Director Option, the optionee will generally recognize capital gain or loss equal to the difference between (i) the amount received upon disposition of the shares, and (ii) the sum of the option price and the amount included in the optionee's income when the Director Option was exercised. Such gain will be long-term or short-term depending upon whether the shares were held for at least one year after the date of exercise.

A grantee of shares of restricted stock pursuant to a Restricted Stock Award will recognize ordinary income for federal income tax purposes in the year of receipt, measured by the value of the shares received determined without regard to the transfer restriction or other restrictions relating to such issue. Any gain or loss recognized upon the sale of the shares will generally be treated as capital gain or loss and will be long-term or short-term depending upon the holding period of the shares.

Under current law, any gain realized by a optionee or a grantee, as the case may be, other than long-term capital gain is taxable at a maximum federal income tax rate of 39.6%. Long-term capital gain is taxable at a maximum federal income tax rate of 28%.

The Company will be entitled to a tax deduction in connection with Stock Rights under the 1996 Director Plan in an amount equal to the ordinary income realized by the optionee or grantee, as the case may be, and at the time he or she recognizes such income.

VOTE REQUIRED

Adoption of the 1996 Director Plan will require the affirmative vote of the holders of a majority of the outstanding shares of the Company's Common Stock present in person or represented by proxy at the Annual Meeting and entitled to vote. Abstentions are considered shares of stock present in person or represented by proxy at the meeting and entitled to vote and are counted in determining the number of votes necessary for a majority. An abstention will therefore have the practical effect of voting against adoption of the 1996 Director Plan because it represents one fewer vote for adoption of the 1996 Director Plan. Broker non-votes are not considered shares present in person or represented by proxy and entitled to vote on the 1996 Director Plan and will have no effect on the vote. The Board of Directors recommends that the stockholders vote FOR the adoption of the 1996 Director Plan.

## ANNUAL REPORT

A copy of the Company's Annual Report for 1996 is being mailed to the Company's stockholders with this Proxy Statement.

## STOCKHOLDER PROPOSALS

Any stockholder who, in accordance with and subject to the provisions of the proxy rules of the SEC, wishes to submit a proposal for inclusion in the Company's proxy statement for its 1998 Annual Meeting of Stockholders must deliver such proposal in writing to the Company's Secretary at the Company's principal executive offices at 1195 River Road, Marietta, Pennsylvania 17547, not later than November 24, 1997.

## OTHER PROPOSALS

The Board of Directors does not know of any matters to be presented for consideration at the Annual Meeting other than the matters described in the Notice of Annual Meeting, but if any matters are properly presented, it is the intention of the persons named in the accompanying proxy to vote on such matters in accordance with their judgment.

By Order of the Board of Directors,

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

March 24, 1997

Independent Auditors' Consent and Report on Schedules

The Board of Directors
Donegal Group Inc.:

The audits referred to in our report dated March 3, 1997, included the related financial statement schedules as of December 31, 1996, and for each of the years in the three-year period ended December 31, 1996, incorporated by reference in Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

We consent to the use of our reports incorporated by reference in the registration statements (Nos. 333-06681, 33-85128 and 33-31287) on Form S-8 of Donegal Group Inc.

KPMG PEAT MARWICK LLP

Harrisburg, Pennsylvania
March 27, 1997

| YEAR |
| --- |
| DEC-31-1996 |
| DEC-31-1996 |
| 49,588,543 |
| 111,581,162 |
| 113,461,217 |
| 3,134,198 |
| 0 |
| 0 |
| 185,511,406 |
| 2,912,122 |
| 0 |
| 7,837,899 |
| 273,128,543 |
| 110,022,886 |
| 66,184,188 |
| 0 |
| 0 |
| 8,500,000 |
| 0 |
| 0 |
| 4,540,569 |
| 76,736,802 |
| 273,128,543 |
| 99,982,042 |
| 10,316,468 |
| 172,734 |
| 2,047,787 |
| 66,611,233 |
| 17,032,000 |
| 14,174,023 |
| 11,246,460 |
| 2,350,347 |
| 8,896,113 |
| 0 |
| 0 |
| 0 |
| 8,896,113 |
| 201 |
| 201 |
| 70,040,745 |
| 69,206,233 |
| (2,595,000) |
| 39,988,258 |
| 22,889,000 |
| 73,774,720 |
| (2,595,000) |