

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

FORM 10-K

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

For the fiscal year ended December 31, 2009

OR

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

For the transition period from _____ to _____

Commission file number 0-15341

DONEGAL GROUP INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

23-2424711

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

1195 River Road, Marietta, Pennsylvania

(Address of principal executive offices)

17547

(Zip code)

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

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

Title of Each Class

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

Name of Each Exchange on Which Registered

The NASDAQ Global Select Market
The NASDAQ Global Select Market

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

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

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. \$184,425,596.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: 19,924,944 shares of Class A common stock and 5,576,775 shares of Class B common stock outstanding on February 26, 2010.

DOCUMENTS INCORPORATED BY REFERENCE:

- Portions of the registrant's annual report to stockholders for the fiscal year ended December 31, 2009 are incorporated by reference into Parts I, II and IV of this report.
- Portions of the registrant's proxy statement relating to registrant's annual meeting of stockholders to be held April 15, 2010 are incorporated by reference into Part III of this report.



DONEGAL GROUP INC.
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PART I

Item 1. Business.

(a) General Development of Business.

We are an insurance holding company whose insurance subsidiaries offer personal and commercial lines of property and casualty insurance to businesses and individuals in 18 Mid-Atlantic, Midwestern and Southeastern states. Our insurance subsidiaries provide their policyholders with a selection of insurance products at competitive rates, while pursuing profitability through adherence to a strict underwriting discipline. At December 31, 2009, we had total assets of \$935.6 million and stockholders' equity of \$385.5 million. Our net income was \$18.8 million for the year ended December 31, 2009 compared to \$25.5 million for the year ended December 31, 2008.

Donegal Mutual Insurance Company ("Donegal Mutual") owns approximately 41.9% of our Class A common stock and approximately 75.0% of our Class B common stock. Donegal Mutual's stock ownership in the aggregate represents approximately two-thirds of the voting power of our outstanding common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries have the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Our growth strategies include the acquisition of other insurance companies to expand our business in a given region or to commence operations in a new region. We and Donegal Mutual have the ability to employ a number of acquisition and affiliation methods. Our prior acquisitions and affiliations have taken one of the following forms:

- a purchase of all of the outstanding stock of a stock insurance company;
- a purchase of a book of business;
- a reinsurance transaction; or
- a two-step acquisition of a mutual insurance company in which:
 - as the first step, Donegal Mutual purchases a surplus note from the mutual insurance company, Donegal Mutual enters into a management agreement with the mutual insurance company and Donegal Mutual's designees become a majority of the members of the board of directors of the mutual insurance company.

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- as the second step, the mutual insurance company enters into a quota-share reinsurance agreement with Donegal Mutual or demutualizes, or converts, into a stock insurance company. Upon the conversion, we purchase the surplus note from Donegal Mutual and exchange it for all of the stock of the stock insurance company resulting from the conversion.

We believe that our ability to make direct acquisitions of stock insurance companies and to make indirect acquisitions of mutual insurance companies through a sponsored conversion or a quota-share reinsurance agreement provides us with flexibility that is a competitive advantage in seeking acquisitions. We also believe we have demonstrated our ability to acquire control of an underperforming insurance company, reunderwrite its book of business, reduce its cost structure and return it to profitability.

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

Donegal Mutual completed a quota-share reinsurance transaction with Southern Mutual Insurance Company, a Georgia-domiciled mutual property and casualty insurance company ("Southern Mutual"), effective October 31, 2009. As part of the transaction, Donegal Mutual purchased a \$2.5 million surplus note of Southern Mutual for \$2.5 million in cash. Simultaneously, Southern Mutual elected seven Donegal Mutual designees as members of the 12-member board of directors of Southern Mutual. For the year ended December 31, 2009, Southern Mutual had direct written premium of \$13.3 million. Effective October 31, 2009, Donegal Mutual began to include business assumed from Southern Mutual in its pooling agreement with Atlantic States. As a result, our consolidated results of operations include 80% of Southern Mutual's underwriting activity from and after October 31, 2009.

(b) Financial Information About Industry Segments.

We have three segments, which consist of our investment function, our personal lines function and our commercial lines function. Financial information about these segments is set forth in Note 20 to our consolidated financial statements incorporated by reference in this Form 10-K Report.

(c) Narrative Description of Business.

Who We Are

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

Our insurance subsidiaries derive a substantial portion of their insurance business from smaller to mid-sized regional communities. We believe this focus provides our insurance subsidiaries with competitive advantages in terms of local market knowledge, marketing, underwriting, claims servicing and policyholder service. At the same time, we believe our insurance subsidiaries have cost advantages over many smaller regional insurers because of the centralized accounting, administrative, data processing, investment and other services available to our insurance subsidiaries on a cost-effective basis because of economies of scale.

Strategy

The annual net premiums our insurance subsidiaries earn have increased from \$196.8 million in 2003 to \$355.0 million in 2009, a compound annual growth rate of 10%. Over the same time period, our insurance subsidiaries have achieved a combined ratio consistently more favorable than that of the property and casualty insurance industry as a whole. Our insurance subsidiaries seek to increase their annual net premiums earned and enhance their profitability by:

- *Achieving underwriting profitability.*

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

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

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

The combined ratio of our insurance subsidiaries and that of the property and casualty insurance industry for the years 2005 through 2009 are shown in the following table:

	2005	2006	2007	2008	2009
Our GAAP combined ratio	89.5%	89.0%	91.3%	97.2%	102.2%
Our SAP combined ratio	88.2	87.4	90.2	95.1	101.1
Industry SAP combined ratio(1)	101.2	92.4	95.6	104.7	100.6

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

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

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

- fully automated underwriting and policy issuance systems for both personal and commercial lines;
- training programs;
- marketing support; and

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- field visitations by marketing and underwriting personnel and senior management of our insurance subsidiaries.

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

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

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

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

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

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

Our insurance subsidiaries maintain stringent expense controls under direct supervision of their senior management. We centralize many processing and administrative activities of our insurance subsidiaries to realize operating synergies and better control expenses. Our insurance subsidiaries utilize technology to automate much of their underwriting and to facilitate agency and policyholder communications on an efficient and

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cost-effective basis. We operate on a paperless basis. As a result of our focus on expense control, our insurance subsidiaries have reduced their expense ratio from 36.6% in 1999 to 31.3% in 2009. Our insurance subsidiaries have also increased their annual premium per employee, a measure of efficiency that our insurance subsidiaries use to evaluate their operations, from approximately \$470,000 in 1999 to approximately \$777,000 in 2009.

Our insurance subsidiaries maintain technology comparable to that of the largest of their competitors. "Ease of doing business" is an increasingly important component of an insurer's value to an independent agency. Our insurance subsidiaries provide a fully automated personal lines underwriting and policy issuance system called "WritePro®." WritePro® is a web-based user interface that substantially eases data entry and facilitates the quoting and issuance of policies for our independent agents. Our insurance subsidiaries also provide a similar commercial business system called "WriteBiz®." WriteBiz® is a web-based interface that provides the independent agents of our insurance subsidiaries with an online ability to quote and issue commercial automobile, workers' compensation, businessowners and tradesman policies automatically. As a result, applications of the independent agents for our insurance subsidiaries can become policies without further re-entry of information. Both systems download the policy information to the policy management systems of the independent agents of our insurance subsidiaries.

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

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

- Availability of a state-of-the-art customer call center;
- Availability of a secure website for access to policy information and documents, payment processing and other features;
- Quick replies to information requests and policy submissions; and
- Prompt responses to and processing of claims.

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

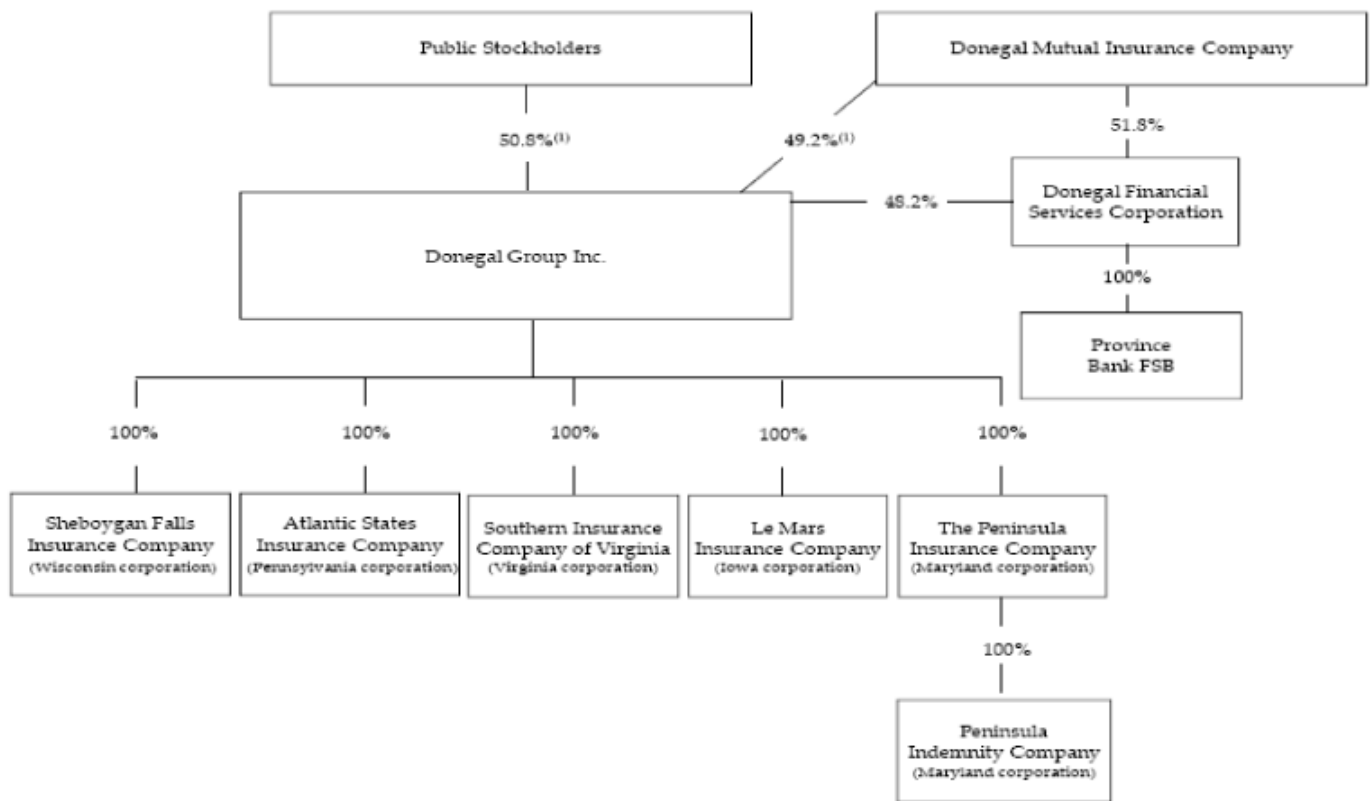
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- *Maintaining premium rate adequacy to enhance the underwriting results of our insurance subsidiaries, while maintaining their existing book of business and preserving their ability to write new business.*

Our insurance subsidiaries seek discipline in their pricing by effecting rate increases to maintain or improve their underwriting profitability without unduly affecting their customer retention. In addition to appropriate pricing, our insurance subsidiaries seek to ensure that their premium rates are adequate relative to their level of underwriting risk. Our insurance subsidiaries review loss trends on a periodic basis to identify changes in the frequency and severity of their claims and to assess the adequacy of their rates and underwriting standards. Our insurance subsidiaries also carefully monitor and audit the information they use to price their policies, enabling them to receive an adequate level of premiums for their risk. For example, our insurance subsidiaries inspect substantially all commercial lines risks and a substantial number of personal lines property risks they insure to determine the adequacy of the insured amount to the value of the insured property, assess property conditions and identify any liability exposures. Our insurance subsidiaries audit the payroll data of their workers' compensation customers to verify that the assumptions used to price a particular policy were accurate. By implementing appropriate rate increases and understanding the risks our insurance subsidiaries insure, they are able to achieve their strategy of achieving consistent underwriting profitability.

Our Organizational Structure

We have six insurance subsidiaries: Atlantic States Insurance Company ("Atlantic States"), Southern Insurance Company of Virginia ("Southern"), Le Mars Insurance Company ("Le Mars"), Peninsula Insurance Group, which consists of The Peninsula Insurance Company and its wholly owned subsidiary, Peninsula Indemnity Company (collectively, the "Peninsula Companies") and Sheboygan. In addition, we benefit from Donegal Mutual's 100% quota-share reinsurance agreement with Southern Mutual and Donegal Mutual's placement of its assumed business from Southern Mutual in the pooling agreement. We also own 48.2% of Donegal Financial Services Corporation ("DFSC"), a registered savings and loan holding company that owns Province Bank FSB, or Province Bank, a federal savings bank that began operations in 2000. Donegal Mutual owns the remaining 51.8% of DFSC. While not material to our operations, we believe Province Bank, with total assets of \$98.4 million at December 31, 2009, complements the product offerings of our insurance subsidiaries. The following chart summarizes our organizational structure and includes all of our property and casualty insurance subsidiaries and Southern Mutual:



(1) Because of the different relative voting power of our Class A common stock and our Class B common stock, our public stockholders hold approximately 33.7% of the aggregate voting power of our Class A common stock and Class B common stock and Donegal Mutual holds approximately 66.3% of the aggregate voting power of our Class A common stock and Class B common stock.

In the mid-1980s, Donegal Mutual recognized the need to develop additional sources of capital and surplus to remain competitive and to have the capacity to expand its business and assure its long-term viability. Donegal Mutual determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company then wholly owned by Donegal Mutual. We in turn formed Atlantic States as our wholly owned subsidiary. We then effected a public offering to provide the surplus necessary to support the business we began to receive on October 1, 1986 pursuant to a proportional reinsurance agreement, or pooling agreement, between Donegal Mutual and Atlantic States that became effective on that date.

Under this pooling agreement, Donegal Mutual and Atlantic States pool substantially all of their respective premiums, losses and loss expenses. Donegal Mutual then cedes 80% of the pooled business to Atlantic States.

As the capital of Atlantic States has increased, its underwriting capacity has increased proportionately. Therefore, as we originally planned in the mid-1980s, Atlantic States has

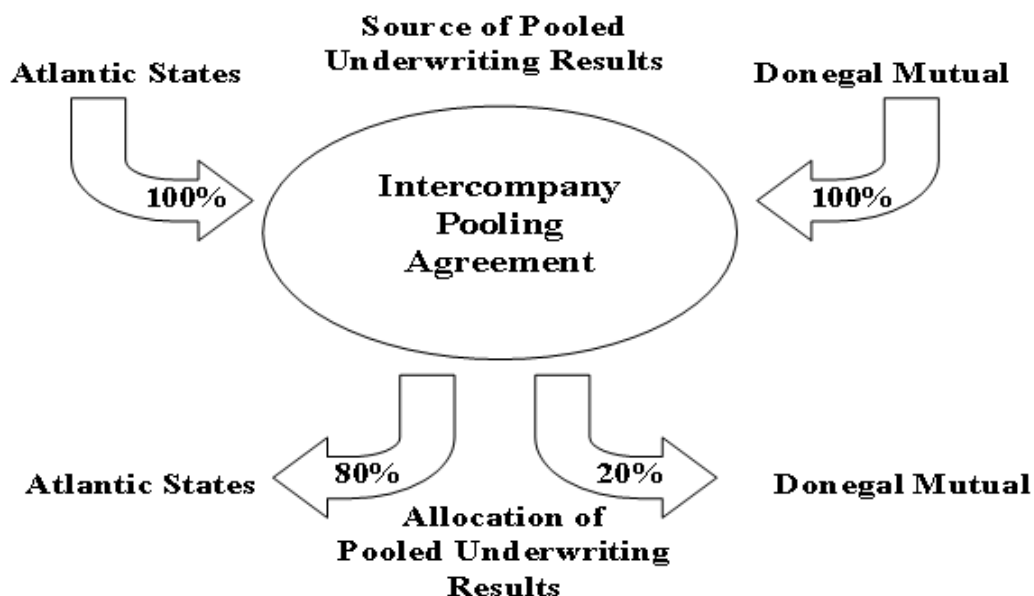
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successfully raised the capital necessary to support the growth of its direct business as well as accept increases in its allocation of business from the underwriting pool, which has increased from an initial allocation of 35% in 1986 to an 80% allocation since March 1, 2008. The size of the underwriting pool has increased substantially. We do not anticipate any further changes in the pooling agreement between Atlantic States and Donegal Mutual in the foreseeable future, including any change in the percentage participation of Atlantic States in the underwriting pool.

Since we established our downstream holding company structure in 1986, Donegal Mutual and our insurance subsidiaries have conducted business together while maintaining their separate legal and corporate existence. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophies, the same management, the same employees, the same facilities and we offer the same types of insurance products.

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

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



Donegal Mutual provides facilities, personnel and other services to us and our insurance subsidiaries. Donegal Mutual allocates certain related expenses to Atlantic States in relation to the relative participation of Donegal Mutual and Atlantic States in the pooling agreement. Our insurance subsidiaries other than Atlantic States reimburse Donegal Mutual for their respective personnel costs and bear their proportionate share of information services costs based on their respective percentage of the total written premiums of the Donegal Insurance Group. Charges for these services totaled \$60.2 million, \$52.3 million and \$48.8 million for 2009, 2008 and 2007, respectively.

We and Donegal Mutual have maintained a coordinating committee since our formation in 1986. The coordinating committee consists of two members of our board of directors, neither of whom is a member of Donegal Mutual's board of directors, and two members of Donegal Mutual's board of directors, neither of whom is a member of our board of directors. The purpose of the coordinating committee is to establish and maintain a process whereby the transactions between Donegal Mutual and our insurance subsidiaries can be the subject of an annual evaluation process, in which both parties have separate approval rights, that considers the fairness of each intercompany transaction to Donegal Mutual and its policyholders and to us and our stockholders.

A new agreement or any change to a previously approved agreement must receive coordinating committee approval. The coordinating committee approval process for a new agreement between Donegal Mutual and us or one of our insurance subsidiaries or a change in such an agreement is as follows:

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- both of our members on the coordinating committee must determine that the new agreement or the change in an existing agreement is fair and equitable to us and in the best interests of our stockholders;
- both of Donegal Mutual's members on the coordinating committee must determine that the new agreement or the change in an existing agreement is fair and equitable to Donegal Mutual and its policyholders;
- the new agreement or the change in an existing agreement must be approved by our board of directors; and
- the new agreement or the change in an existing agreement must be approved by the Donegal Mutual board of directors.

The coordinating committee also meets annually to review each existing agreement between Donegal Mutual and us or our insurance subsidiaries, including a number of reinsurance agreements between Donegal Mutual and our insurance subsidiaries. The purpose of the review is to examine the results of the reinsurance agreements over the past year and over a five-year period and to determine if the terms of the existing agreements remain fair and equitable to us and our stockholders and fair and equitable to Donegal Mutual and its policyholders or if Donegal Mutual and we should mutually agree to certain adjustments. In the case of these reinsurance agreements, the adjustments typically relate to the reinsurance premiums, losses and reinstatement premiums. These agreements are ongoing in nature and will continue in effect throughout 2010 in the ordinary course of business.

Our members on the coordinating committee are Robert S. Bolinger and John J. Lyons. Donegal Mutual's members on the coordinating committee are John E. Hiestand and Frederick W. Dreher. Reference is made to our proxy statement for our annual meeting of stockholders on April 15, 2010 for information on the members of the coordinating committee.

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

- Facilitating the stable management, consistent underwriting discipline, external growth and long-term profitability of our insurance subsidiaries;
- Creating operational and expense synergies given the combined resources and operating efficiencies of Donegal Mutual, us and our insurance subsidiaries;
- Enhancing our opportunities to expand by acquisition because of the ability of Donegal Mutual to acquire control of other mutual insurance companies and

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thereafter demutualize them and then sell them to us at a price that is based on a fairness opinion;

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

Acquisitions

The following table highlights our acquisition history since 1988:

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

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<u>Company Name</u>	<u>State of Domicile</u>	<u>Year Control Acquired(2)</u>	<u>Method of Acquisition</u>
Pioneer Mutual Insurance Company and then Pioneer Insurance Company (1)	New York	1995	Surplus note investment by Donegal Mutual in 1995; demutualization in 1998; acquisition of stock by us in 2001.
Southern Heritage Insurance Company (1)	Georgia	1998	Purchase of stock by us in 1998.
Le Mars Mutual Insurance Company of Iowa and now Le Mars Insurance Company	Iowa	2002	Surplus note investment by Donegal Mutual in 2002; demutualization in 2004; acquisition of stock by us in 2004.
Peninsula Insurance Group	Maryland	2004	Purchase of stock by us in 2004.
Sheboygan Falls Mutual Insurance Company and now Sheboygan Falls Insurance Company	Wisconsin	2007	Contribution note investment by Donegal Mutual in 2007; demutualization in 2008; acquisition of stock by us in 2008.
Southern Mutual Insurance Company	Georgia	2009	Surplus note investment by Donegal Mutual and quota-share reinsurance.

(1) To reduce administrative and compliance costs and expenses, these subsidiaries subsequently merged into one of our existing insurance subsidiaries.

(2) Control acquired by Donegal Mutual or us.

Distribution

Our insurance subsidiaries market their products primarily in the Mid-Atlantic, Midwest and Southeast regions through approximately 2,000 independent insurance agencies. At December 31, 2009, the Donegal Insurance Group actively wrote business in 18 states (Alabama, Delaware, Georgia, Iowa, Maryland, Nebraska, New Hampshire, New York,

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North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Virginia, West Virginia and Wisconsin). We believe the relationships of our insurance subsidiaries with their independent agents are valuable in identifying, obtaining and retaining profitable business. Our insurance subsidiaries maintain a stringent agency selection procedure that emphasizes appointing agencies with proven marketing strategies for the development of profitable business, and our insurance subsidiaries only appoint agencies with a strong underwriting history and potential growth capabilities. Our insurance subsidiaries also regularly evaluate the independent agencies that represent them based on their profitability and performance in relation to the objectives of our insurance subsidiaries. Our insurance subsidiaries seek to be among the top three insurers within each of their agencies for the lines of business they write.

The following table sets forth the percentage of direct premiums our insurance subsidiaries write, including 80% of the direct premiums Donegal Mutual and Atlantic States write, in each of the states where they conducted a significant portion of their business in 2009:

Pennsylvania	46.6%
Maryland	11.7
Virginia	10.9
Georgia	7.0
Delaware	6.4
Ohio	3.5
Iowa	3.1
Wisconsin	2.4
Tennessee	1.9
Nebraska	1.5
South Dakota	1.4
Oklahoma	1.0
Other	2.6
Total	<u>100.0%</u>

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

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independent agents ongoing support that better enables the agents to attract and retain customers, including:

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

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

Products

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

Personal

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

Commercial

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

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- Commercial multi-peril — policies that provide protection to businesses against many perils, usually combining liability and physical damage coverages.
- Workers' compensation — policies employers purchase to provide benefits to employees for injuries sustained during employment. The workers' compensation laws of each state determine the extent of the coverage we provide.

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

(dollars in thousands)	Year Ended December 31,					
	2007		2008		2009	
Net Premiums Written:	Amount	%	Amount	%	Amount	%
Personal lines:						
Automobile	\$132,452	42.2%	\$154,091	42.2%	\$161,932	44.6%
Homeowners	58,602	18.7	72,195	19.8	77,420	21.3
Other	11,299	3.6	13,254	3.6	13,135	3.6
Total personal lines	<u>\$202,353</u>	<u>64.5</u>	<u>\$239,540</u>	<u>65.6</u>	<u>\$252,487</u>	<u>69.5</u>
Commercial lines:						
Automobile	32,059	10.2	\$ 35,959	9.9	\$ 34,054	9.4
Workers' compensation	32,361	10.3	36,459	10.0	28,921	8.0
Commercial multi-peril	43,559	13.9	49,004	13.4	44,000	12.1
Other	3,357	1.1	3,979	1.1	3,767	1.0
Total commercial lines	<u>\$111,336</u>	<u>35.5</u>	<u>\$125,401</u>	<u>34.4</u>	<u>\$110,742</u>	<u>30.5</u>
Total business	<u>\$313,689</u>	<u>100.0%</u>	<u>\$364,941</u>	<u>100.0%</u>	<u>\$363,229</u>	<u>100.0%</u>

Underwriting

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

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

- assess and select quality standard and preferred risks;
- adhere to disciplined underwriting and reunderwriting guidelines;

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- inspect substantially all commercial lines risks and a substantial number of personal lines property risks; and
- utilize various types of risk management and loss control services.

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

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

Claims

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

The claims departments of our insurance subsidiaries rigorously manage claims to assure that they settle legitimate claims quickly and fairly and that they identify questionable claims for defense. In the majority of cases, the personnel of our insurance subsidiaries, who have significant experience in the property and casualty insurance industry and know the service philosophy of our insurance subsidiaries, adjust claims. Our insurance subsidiaries provide various means of claims reporting on 24-hours a day, seven-day a week basis, including toll-free numbers and electronic reporting through our website. Our insurance subsidiaries strive to respond to notifications of claims promptly, generally within the day reported. Our insurance subsidiaries believe that by responding promptly to claims, they provide quality customer service and minimize the ultimate cost of the claims. Our insurance subsidiaries engage independent adjusters as needed to handle claims in areas in which the volume of claims is not sufficient to justify our hiring of internal claims adjusters.

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Our insurance subsidiaries also employ private adjusters and investigators, structural experts and various outside legal counsel to supplement our in-house staff and to assist in the investigation of claims. Our insurance subsidiaries have a special investigative unit staffed by former law enforcement officers that attempts to identify and prevent fraud and abuse and to control questionable claims.

The management of the claims departments of our insurance subsidiaries develops and implements policies and procedures for the establishment of adequate claim reserves. Our insurance subsidiaries employ an actuarial staff that regularly reviews their reserves for incurred but not reported claims. The management and staff of the claims departments resolve policy coverage issues, manage and process reinsurance recoveries and handle salvage and subrogation matters. The litigation and personal injury sections of our insurance subsidiaries manage all claims litigation, and branch office claims above certain thresholds require home office review and settlement authorization. Our insurance subsidiaries provide their claims adjusters reserving and settlement authority based upon their experience and demonstrated abilities. Larger or more complicated claims require consultation and approval of senior department management.

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

Liabilities for Losses and Loss Expenses

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

Our insurance subsidiaries maintain liabilities for the payment of losses and loss expenses with respect to both reported and unreported claims. Our insurance subsidiaries establish these liabilities for the purpose of covering the ultimate costs of settling all losses, including investigation and litigation costs. Our insurance subsidiaries base the amount of their liability for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the insurance policy provisions relating to the type of loss. Our insurance subsidiaries determine the amount of

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their liability for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for losses.

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on workers' compensation claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on workers' compensation claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and legal decisions that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and the collectability of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at December 31, 2009. For every 1% change in our insurance subsidiaries' loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$1.8 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, since the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and, in other periods their estimates have exceeded their actual liabilities. Changes in our

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insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$9.8 million, \$2.7 million and (\$10.0) million in 2009, 2008 and 2007, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and there have been no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in those years. The majority of the 2009 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2009 development represented 6.0% of our December 31, 2008 carried reserves and was driven primarily by higher-than-expected severity in the private passenger automobile liability, homeowners and workers' compensation lines of business in accident year 2008. The 2008 development represented 1.2% of our December 31, 2007 carried reserves and was driven primarily by higher-than-expected severity in the private passenger automobile liability line of business in accident year 2007. We recognized favorable development in 2007 related primarily to the private passenger automobile liability, workers' compensation, commercial automobile liability and commercial multi-peril lines of business.

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

Differences between liabilities reported in our financial statements prepared on the basis of generally accepted accounting principles ("GAAP") and our insurance subsidiaries' financial statements prepared on a statutory accounting basis ("SAP") result from anticipating salvage and subrogation recoveries for GAAP but not for SAP. These differences amounted to \$8.3 million, \$8.7 million and \$9.2 million at December 31, 2007, 2008 and 2009, respectively.

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

(in thousands)	Year Ended December 31,		
	2007	2008	2009
Gross liability for unpaid losses and loss expenses at beginning of year	\$259,022	\$226,432	\$239,809
Less reinsurance recoverable	95,710	76,280	78,502
Net liability for unpaid losses and loss expenses at beginning of year	163,312	150,152	161,307
Acquisition of Sheboygan	—	2,173	—
Provision for net losses and loss expenses for claims incurred in the current year	187,797	221,617	241,012
Change in provision for estimated net losses and loss expenses for claims incurred in prior years	(10,013)	2,684	9,823
Total incurred	177,784	224,301	250,835
Net losses and loss payments for claims incurred during:			
The current year	118,444	143,369	152,293
Prior years	72,500	71,950	79,587
Total paid	190,944	215,319	231,880
Net liability for unpaid losses and loss expenses at end of year	150,152	161,307	180,262
Plus reinsurance recoverable	76,280	78,502	83,337
Gross liability for unpaid losses and loss expenses at end of year	\$226,432	\$239,809	\$263,599

The following table sets forth the development of the liability for net unpaid losses and loss expenses of our insurance subsidiaries from 1999 to 2009. Loss data in the table includes business ceded to Atlantic States from the underwriting pool.

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

The “Net liability reestimated as of” portion of the table shows the reestimated amount of the previously recorded liability based on experience for each succeeding year. The estimate increases or decreases as payments are made and more information becomes known about the severity of the remaining unpaid claims. For example, the 2005 liability has developed a redundancy after four years because we expect the reestimated net losses and loss expenses to be \$22.8 million less than the estimated liability we initially established in 2005 of \$173.0 million.

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The "Cumulative (excess) deficiency" shows the cumulative excess or deficiency at December 31, 2009 of the liability estimate shown on the top line of the corresponding column. An excess in liability means that the liability established in prior years exceeded actual net losses and loss expenses or our insurance subsidiaries reevaluated the liability at less than the original estimate. A deficiency in liability means that the liability established in prior years was less than actual net losses and loss expenses or our insurance subsidiaries reevaluated the liability at more than the original estimate.

The "Cumulative amount of liability paid through" portion of the table shows the cumulative net losses and loss expense payments made in succeeding years for net losses incurred prior to the balance sheet date. For example, the 2005 column indicates that as of December 31, 2009 payments equal to \$133.8 million of the currently reestimated ultimate liability for net losses and loss expenses of \$150.2 million had been made.

Amounts shown in the 2004 column of the table include information for Le Mars and the Peninsula Companies for all accident years prior to 2004. Amounts shown in the 2008 column of the table include information for Sheboygan for all accident years prior to 2008.

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(in thousands)	Year Ended December 31,										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Net liability at end of year for unpaid losses and loss expenses	\$ 99,234	\$ 102,709	\$ 114,544	\$ 131,108	\$ 138,896	\$ 171,431	\$ 173,009	\$ 163,312	\$ 150,152	\$ 161,307	\$ 180,262
Net liability reestimated as of:											
One year later	100,076	110,744	121,378	130,658	136,434	162,049	159,393	153,299	152,836	171,130	
Two years later	103,943	112,140	120,548	128,562	130,030	152,292	153,894	150,934	154,435		
Three years later	104,073	110,673	118,263	124,707	123,399	148,612	151,792	150,078			
Four years later	101,880	108,766	114,885	119,817	120,917	147,280	150,183				
Five years later	100,715	107,561	113,070	118,445	119,968	145,874					
Six years later	100,479	106,950	112,614	118,605	119,731						
Seven years later	99,968	106,298	112,921	118,905							
Eight years later	99,927	106,835	113,350								
Nine years later	100,223	107,474									
Ten years later	100,837										
Cumulative (excess) deficiency	<u>1,603</u>	<u>4,765</u>	<u>(1,194)</u>	<u>(12,203)</u>	<u>(19,165)</u>	<u>(25,557)</u>	<u>(22,826)</u>	<u>(13,234)</u>	<u>4,283</u>	<u>9,823</u>	

Cumulative amount of liability paid through:											
One year later	\$ 39,060	\$ 43,053	\$ 45,048	\$ 46,268	\$ 51,965	\$ 67,229	\$ 71,718	72,499	71,950	79,592	
Two years later	60,622	67,689	70,077	74,693	81,183	102,658	107,599	104,890	105,576		
Three years later	76,811	82,268	87,198	93,288	99,910	123,236	125,926	121,711			
Four years later	85,453	92,127	97,450	105,143	109,964	133,844	133,805				
Five years later	91,337	98,007	104,551	111,523	113,684	136,377					
Six years later	94,420	101,664	108,136	114,145	114,499						
Seven years later	96,823	103,767	110,193	114,641							
Eight years later	98,268	105,046	110,447								
Nine years later	98,847	104,990									
Ten years later	98,283										

	Year Ended December 31									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	
Gross liability at end of year	\$ 179,840	\$ 210,692	\$ 217,914	\$ 267,190	\$ 265,730	\$ 259,022	\$ 226,432	\$ 239,809	\$ 263,599	
Reinsurance recoverable	65,296	79,584	79,018	95,759	92,721	95,710	76,280	78,502	83,337	
Net liability at end of year	114,544	131,108	138,896	171,431	173,009	163,312	150,152	161,307	180,262	
Gross reestimated liability — latest	191,184	207,187	207,667	237,608	238,713	238,592	232,342	253,179		
Reestimated recoverable — latest	77,834	88,282	87,936	91,734	88,530	88,514	77,907	82,049		
Net reestimated liability — latest	113,350	118,905	119,731	145,874	150,183	150,078	154,435	171,130		
Gross cumulative deficiency (excess)	11,344	(3,505)	(10,247)	(29,582)	(27,017)	(20,430)	5,910	13,370		

Technology

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

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

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

Third-Party Reinsurance

Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, the Peninsula Companies and Sheboygan also have separate reinsurance programs that provide certain coverage that is commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with the requirements of our insurance subsidiaries and Donegal

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Mutual, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating from A.M. Best.

The external reinsurance our insurance subsidiaries and Donegal Mutual purchase includes:

- “excess of loss reinsurance,” under which their losses are automatically reinsured, through a series of contracts, over a set retention (generally \$750,000 for 2009); and
- “catastrophic reinsurance,” under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (generally \$3.0 million for 2009).

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.

Our insurance subsidiaries' principal third-party reinsurance agreement in 2009 was a multi-line per risk excess of loss treaty that provided 100% coverage up to \$1.0 million for both property and liability losses over the set retention.

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

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

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

Competition

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

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insurance products of our insurance subsidiaries and those of Donegal Mutual are marketed exclusively through independent insurance agencies, most of which represent more than one insurance company, our insurance subsidiaries face competition within agencies as well as competition to retain qualified independent agents.

Investments

Return on invested assets is an important element of the financial results of our insurance subsidiaries, and the investment strategy of our insurance subsidiaries is to generate an appropriate amount of after-tax income on invested assets while minimizing credit risk through investments in high-quality securities. As a result, our insurance subsidiaries seek to invest a high percentage of their assets in diversified, highly rated and marketable fixed-maturity instruments. The fixed-maturity portfolios of our insurance subsidiaries consist of both taxable and tax-exempt securities. Our insurance subsidiaries maintain a portion of their portfolios in short-term securities, such as investments in commercial paper, to provide liquidity for the payment of claims and operation of their businesses. Our insurance subsidiaries maintain a negligible percentage (less than 1.5% at December 31, 2009) of their portfolios in equity securities.

At December 31, 2009, 99.8% of all debt securities held by our insurance subsidiaries had an investment-grade rating. The investment portfolios of our insurance subsidiaries did not contain any mortgage loans or any non-performing assets at December 31, 2009.

The following table shows the composition of the debt securities (at carrying value) in the investment portfolios of our insurance subsidiaries, excluding short-term investments, by rating as of December 31, 2009:

(dollars in thousands)

Rating ⁽¹⁾	December 31, 2009	
	Amount	Percent
U.S. Treasury and U.S. agency securities ⁽²⁾	\$137,399	23.2%
Aaa or AAA	202,624	34.3
Aa or AA	163,692	27.7
A	82,247	13.9
BBB	2,597	0.5
BB	250	—
B	1,254	0.2
CCC	1,448	0.2
Total	<u>\$591,511</u>	<u>100.0%</u>

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

(2) Includes residential mortgage-backed securities of \$94.8 million.

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Our insurance subsidiaries invest in both taxable and tax-exempt securities as part of their strategy to maximize after-tax income and are currently increasing their investments in tax-exempt securities. This strategy considers, among other factors, the alternative minimum tax. Tax-exempt securities made up approximately 67.9%, 75.8% and 71.0% of the debt securities in the combined investment portfolios of DGI and its insurance subsidiaries at December 31, 2007, 2008 and 2009, respectively.

The following table shows the classification of our investments and the investments of our insurance subsidiaries (at carrying value) at December 31, 2007, 2008 and 2009:

	December 31,					
	2007		2008		2009	
(dollars in thousands)	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Fixed maturities(1):						
Held to maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 51,611	8.5%	\$ 8,517	1.4%	\$ 2,000	0.3%
Obligations of states and political subdivisions	81,457	13.5	76,451	12.1	61,736	9.3
Corporate securities	9,838	1.6	8,341	1.3	6,243	0.9
Residential mortgage-backed securities	11,384	1.9	6,569	1.0	3,828	0.6
Total held to maturity	<u>154,290</u>	<u>25.5</u>	<u>99,878</u>	<u>15.8</u>	<u>73,807</u>	<u>11.1</u>
Available for sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	25,374	4.2	6,630	1.0	40,630	6.1
Obligations of states and political subdivisions	251,866	41.6	337,003	53.3	358,367	53.7
Corporate securities	15,228	2.5	23,936	3.8	27,766	4.2
Residential mortgage-backed securities	43,850	7.2	78,247	12.4	90,941	13.6
Total available for sale	<u>336,318</u>	<u>55.5</u>	<u>445,816</u>	<u>70.5</u>	<u>517,704</u>	<u>77.6</u>
Total fixed maturities	490,608	81.0	545,694	86.3	591,511	88.7
Equity securities(2)	36,361	6.0	5,895	0.9	9,915	1.5
Investments in affiliates(3)	8,649	1.4	8,594	1.4	9,309	1.4
Short-term investments(4)	70,252	11.6	71,953	11.4	56,100	8.4
Total investments	<u>\$605,870</u>	<u>100.0%</u>	<u>\$632,136</u>	<u>100.0%</u>	<u>\$666,835</u>	<u>100.0%</u>

(1) See Notes 1 and 5 to our consolidated financial statements incorporated by reference herein. We value fixed maturities classified as held to maturity at amortized cost; we value those fixed maturities classified as available for sale at fair value. Total fair value of fixed maturities classified as held to maturity was \$155.4 million at December 31, 2007, \$101.5 million at December 31, 2008 and \$77.0 million at December 31, 2009. The amortized cost of fixed maturities classified as available for sale was \$331.8 million at December 31, 2007, \$449.0 million at December 31, 2008 and \$503.7 million at December 31, 2009.

(2) We value equity securities at fair value. Total cost of equity securities was \$30.0 million at December 31, 2007, \$2.9 million at December 31, 2008 and \$3.8 million at December 31, 2009.

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

The following table sets forth the maturities (at carrying value) in fixed maturity and short-term investment portfolios of DGI and its insurance subsidiaries at December 31, 2007, December 31, 2008 and December 31, 2009:

	2007		December 31, 2008		2009	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
(dollars in thousands)						
Due in(1):						
One year or less	\$ 29,299	6.0%	\$ 14,008	2.6%	\$ 16,410	2.8%
Over one year through three years	61,523	12.5	33,772	6.2	35,007	5.9
Over three years through five years	36,360	7.4	44,579	8.2	46,392	7.8
Over five years through ten years	186,441	38.0	174,130	31.9	166,352	28.1
Over ten years through fifteen years	86,089	17.5	89,889	16.5	121,308	20.5
Over fifteen years	35,662	7.3	104,500	19.1	111,273	18.9
Residential mortgage-backed securities	55,234	11.3	84,816	15.5	94,769	16.0
	<u>\$490,608</u>	<u>100.0%</u>	<u>\$545,694</u>	<u>100.0%</u>	<u>\$591,511</u>	<u>100.0%</u>

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

As shown above, our insurance subsidiaries held investments in residential mortgage-backed securities having a carrying value of \$94.8 million at December 31, 2009. The mortgage-backed securities consist primarily of investments in governmental agency balloon pools with stated maturities between one and 24 years. The stated maturities of these investments limit the exposure of our insurance subsidiaries to extension risk should interest rates rise and prepayments decline. Our insurance subsidiaries perform an analysis of the underlying loans when evaluating a residential mortgage-backed security for purchase, and they select those securities that they believe will provide a return that properly reflects the prepayment risk associated with the underlying loans.

The following table sets forth the investment results of DGI and its insurance subsidiaries for the years ended December 31, 2007, 2008 and 2009:

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(dollars in thousands)	Year Ended December 31,		
	2007	2008	2009
Invested assets(1)	\$598,604	\$619,003	\$649,486
Investment income(2)	22,785	22,756	20,631
Average yield	3.8%	3.7%	3.2%
Average tax-equivalent yield	4.8	4.9	4.4

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

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

A.M. Best Rating

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

Regulation

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

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require the filing of annual and other reports relating to the financial condition of insurance companies.

In addition to state-imposed insurance laws and regulations, the National Association of Insurance Commissioners (the "NAIC") has established a risk-based capital system for assessing the adequacy of statutory capital and surplus that augments the states' current fixed dollar minimum capital requirements for insurance companies. At December 31, 2009, our insurance subsidiaries and Donegal Mutual each exceeded the minimum levels of statutory capital the risk-based capital rules require by a substantial margin.

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

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

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

Approval of the applicable insurance commissioner is also required prior to consummation of transactions affecting the control of an insurer. In virtually all states, including Pennsylvania, Iowa, Maryland, Virginia and Wisconsin where our insurance

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subsidiaries are domiciled, the acquisition of 10% or more of the outstanding capital stock of an insurer or its holding company or the intent to acquire such an interest creates a rebuttable presumption of a change in control. Pursuant to an order issued in April 2003, the Department approved Donegal Mutual's ownership of up to 70% of our outstanding Class A common stock and up to 100% of our outstanding Class B common stock.

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

The insurance laws of the respective states of domicile of our insurance subsidiaries restrict the amount of dividends or other distributions our insurance subsidiaries may pay to us without the prior approval of the insurance regulatory authorities of that state. Generally, the maximum amount that an insurance subsidiary may pay during any year after notice to, but without prior approval of, the insurance commissioners of these states is limited to a stated percentage of that subsidiary's statutory capital and surplus as of the end of the preceding year or the net income of the subsidiary for the preceding year. As of December 31, 2009, the amount of dividends our insurance subsidiaries could pay us during 2010, without the prior approval of the various insurance commissioners, was:

Name of Insurance Subsidiary	Ordinary Dividend Amount
Atlantic States	\$ 12.4million
Southern	None
Le Mars	2.8million
Peninsula Companies	3.9million
Sheboygan	0.6million
Total	<u>\$ 19.7million</u>

Donegal Mutual

Donegal Mutual organized as a mutual fire insurance company in Pennsylvania in 1889. At December 31, 2009, Donegal Mutual had admitted assets of \$325.0 million and

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policyholders' surplus of \$172.1 million. At December 31, 2009, Donegal Mutual had total liabilities of \$152.9 million, including debt of \$13.1 million, reserves for net losses and loss expenses of \$44.3 million and unearned premiums of \$29.3 million. Donegal Mutual's investment portfolio of \$221.6 million at December 31, 2009 consisted primarily of investment-grade bonds of \$18.5 million and its investment in our common stock. At December 31, 2009, Donegal Mutual owned 8,355,184 shares, or approximately 42% of our Class A common stock, Donegal Mutual carried on its books at \$111.6 million, and 4,180,234 shares, or approximately 75%, of our Class B common stock, Donegal Mutual carried on its books at \$55.8 million. The foregoing financial information is presented on the statutory basis of accounting required by the NAIC Accounting Practices and Procedures Manual. Donegal Mutual does not, nor is it required to, prepare financial statements in accordance with generally accepted accounting principles.

Donegal Financial Services Corporation

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

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

Cautionary Statement Regarding Forward-Looking Statements

This annual report and the documents incorporated by reference into this annual report contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include certain discussions relating to underwriting, premium and investment income volume, business strategies, reserves, profitability and business relationships and our other business activities during 2009 and beyond. In some cases, you can identify forward-looking statements by terms such as "may,"

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“will,” “should,” “could,” “would,” “expect,” “plan,” “intend,” “anticipate,” “believe,” “estimate,” “objective,” “project,” “predict,” “potential,” “goal” and similar expressions. These forward-looking statements reflect our current views about future events, are based on our current assumptions and are subject to known and unknown risks and uncertainties that may cause our results, performance or achievements to differ materially from those anticipated in or implied by those statements. Many of the factors that will determine future events or achievements are beyond our ability to control or predict. Such factors may include those described under “Risk Factors.” The forward-looking statements contained in this annual report reflect our views and assumptions only as of the date of this Form 10-K Report. Except as required by law, we do not intend to, and assume no responsibility for, updating any forward-looking statements. We qualify all of our forward-looking statements by these cautionary statements.

Available Information

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

Item 1A. Risk Factors.

Risk Factors

Risks Relating to Us and Our Business

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

Donegal Mutual controls the election of all of the members of our board of directors. Five of the 11 members of our board of directors are also directors of Donegal Mutual. Donegal Mutual and we have the same executive officers. These common directors and executive officers have a fiduciary duty to our stockholders and also have a fiduciary duty to the policyholders of Donegal Mutual. Among the potential conflicts of interest that could arise from these separate fiduciary duties are:

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- We and Donegal Mutual periodically review the percentage participation of Atlantic States and Donegal Mutual in the underwriting pool that the two companies have maintained since 1986;
- Our insurance subsidiaries and Donegal Mutual annually review and then establish the terms of certain reinsurance agreements between them with the objective over the long-term of having an approximately equal balance between payments and recoveries;
- We and Donegal Mutual periodically allocate certain shared expenses among Donegal Mutual, us and our insurance subsidiaries in accordance with various inter-company expense-sharing agreements; and
- Our insurance subsidiaries may enter into other transactions or contractual relationships with Donegal Mutual, including, for example, our purchases from time to time from Donegal Mutual of the surplus note of a mutual insurance company that will convert into a stock insurance company.

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

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

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

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

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

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

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

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

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

We have 2,000,000 authorized shares of preferred stock that we could issue in one or more series without further stockholder approval, unless otherwise required by law, and upon such terms and conditions, and having such rights, privileges and preferences, as our

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board of directors may determine our potential issuance of preferred stock and that may make it difficult for a third party to acquire control of us.

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

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

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

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

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

Our insurance subsidiaries market their insurance products solely through a network of approximately 2,000 independent insurance agencies. This agency force is one of the most important components of the competitive profile of our insurance subsidiaries. As a result, our insurance subsidiaries are materially dependent upon the independent agents they use,

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each of whom has the authority to bind our insurance subsidiaries to insurance policies. To the extent that our independent agents' marketing efforts cannot maintain their current levels of volume and quality or they bind our insurance subsidiaries to unacceptable insurance risks, fail to comply with the established underwriting guidelines of our insurance subsidiaries or otherwise inappropriately market the products of our insurance subsidiaries, the business, financial condition and results of operations of our insurance subsidiaries could suffer.

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

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

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

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

We are dependent on dividends from our insurance subsidiaries for the payment of our operating expenses, our debt service and dividends to our stockholders; however, there are regulatory

restrictions and business considerations that limit the amount of dividends our insurance subsidiaries may pay to us.

As a holding company, we rely primarily on dividends from our insurance subsidiaries as a source of funds to meet our corporate obligations. The amount of dividends our insurance subsidiaries can pay to us is subject to regulatory restrictions and depends on the amount of surplus our subsidiaries maintain. From time to time, the NAIC and various state insurance regulators consider modifying the method of determining the amount of dividends that an insurance company may pay without prior regulatory approval. The maximum amount of ordinary dividends that our insurance subsidiaries can pay to us in 2010 without prior regulatory approval is approximately \$19.7 million. Other business and regulatory considerations, such as the impact of dividends on surplus that could affect the ratings, competitive conditions, the investment results of our subsidiaries and the amount of premiums that our insurance subsidiaries can write could also adversely impact the ability of our insurance subsidiaries to pay dividends to us.

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

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

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

The affiliation with and acquisition of smaller and other undercapitalized insurance companies involves risks that could adversely affect our results of operations and financial condition. The risks associated with these affiliations and acquisitions include:

- the potential inadequacy of reserves for loss and loss expenses;
- the need to supplement management with additional experienced personnel;
- conditions imposed by regulatory agencies that make the realization of cost-savings through integration of operations more difficult;

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- a need for additional capital that was not anticipated at the time of the acquisition; and
- the use of more of our management's time than we originally anticipated.

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

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

Many of the competitors of our insurance subsidiaries have greater financial strength than our insurance subsidiaries, and these competitors may be able to offer their products at lower prices than our insurance subsidiaries can afford to do.

The property and casualty insurance industry is intensely competitive. Competition can be based on many factors, including:

- the perceived financial strength of the insurer;
- premium rates;
- policy terms and conditions;
- policyholder service;
- reputation; and
- experience.

Our insurance subsidiaries compete with many regional and national property and casualty insurance companies, including direct sellers of insurance products, insurers having their own agency organizations and other insurers represented by independent agents. Many of these insurers have greater capital than our insurance subsidiaries, have substantially greater financial, technical and operating resources and have equal or higher ratings from A.M. Best than our insurance subsidiaries. In addition, competition may

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become increasingly better capitalized in the future as the traditional barriers between insurance companies and other financial institutions erode and as the property and casualty insurance industry continues to consolidate.

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

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

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

The investments of our insurance subsidiaries are also subject to risk resulting from interest rate fluctuations. Increasing interest rates or a widening in the spread between interest rates available on U.S. Treasury securities and corporate debt or asset-backed securities, for example, will typically have an adverse impact on the market values of fixed-rate securities. If interest rates decline, our insurance subsidiaries would generally achieve a lower overall rate of return on investments of cash generated from their operations. In addition, in the event of the call or maturity of investments in a declining interest rate

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environment, our insurance subsidiaries may not be able to reinvest the proceeds in securities with comparable interest rates. Changes in interest rates may reduce both the profitability and the return on the invested capital of our insurance subsidiaries.

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

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

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

Our insurance subsidiaries rely on reinsurance agreements to limit their maximum net loss from large single catastrophic risks or excess of loss risks in areas where insurance subsidiaries may have a concentration of policyholders. Reinsurance also enables our insurance subsidiaries to increase their capacity to write insurance. Although the reinsurance our insurance subsidiaries maintain provides that the reinsurer is liable to them for any reinsured losses, the reinsurance does not relieve our insurance subsidiaries from their primary liability to their policyholders if the reinsurer fails to pay our insurance subsidiaries. To the extent that a reinsurer is unable to pay losses for which it is liable to our insurance subsidiaries, our insurance subsidiaries remain liable for such losses. As of December 31, 2009, our insurance subsidiaries had approximately \$24.0 million of reinsurance receivables from third-party reinsurers relating to paid and unpaid losses. Any insolvency or inability of these reinsurers to make timely payments to our insurance subsidiaries under the terms of their reinsurance agreements would adversely affect the results of operations of our insurance subsidiaries.

In addition, our insurance subsidiaries face a risk of the non-availability of reinsurance or an increase in reinsurance costs that could adversely affect their ability to write business or their results of operations. Market conditions beyond the control of our insurance subsidiaries, such as the amount of surplus in the reinsurance market and the frequency and severity of natural and man-made catastrophes, affect both the availability and the cost of the reinsurance our insurance subsidiaries purchase. If our insurance subsidiaries can not

maintain their current level of reinsurance or purchase new reinsurance protection in amounts that our insurance subsidiaries consider sufficient, our insurance subsidiaries would either have to be willing to accept an increase in their net risk retention or reduce their insurance writings which would adversely affect them.

Risks Relating to the Property and Casualty Insurance Industry

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

Loss severity in the property and casualty insurance industry has increased in recent years, principally driven by larger court judgments and increasing medical costs. In addition, many classes of complainants have brought legal actions and proceedings that tend to increase the size of judgments. The propensity of policyholders and third-party claimants to litigate and the willingness of courts to expand causes of loss and the size of awards to eliminate exclusions and to increase coverage limits may make the loss reserves of our insurance subsidiaries inadequate for current and future losses.

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

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

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

Property and casualty insurers are subject to extensive supervision in their domiciliary states and in the states in which they do business. This regulatory oversight includes, by way of example, matters relating to licensing and examination, approval of premium rates, market conduct, policy forms, limitations on the nature and amount of certain investments, claims practices, mandated participation in involuntary markets and guaranty funds, reserve adequacy, insurer solvency, transactions between affiliates, the amount of dividends that

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insurers may pay and restrictions on underwriting standards. Such regulation and supervision are primarily for the benefit and protection of policyholders rather than stockholders. For instance, our insurance subsidiaries are subject to involuntary participation in specified markets in various states in which they operate, and the premium rates our insurance subsidiaries may charge do not always correspond with the underlying costs of providing that coverage.

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

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

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

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

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

One of the distinguishing features of the property and casualty insurance industry is that it prices its products before it knows its costs since insurers generally establish their premium rates before they know the amount of losses they will incur. Accordingly, our insurance subsidiaries establish premium rates from forecasts of the ultimate costs they expect to arise from risks they have underwritten during the policy period. These premium rates may not be sufficient to cover the ultimate losses incurred. Further, our insurance subsidiaries must establish reserves for losses and loss expenses as balance sheet liabilities based upon estimates involving actuarial and statistical projections at a given time of what our insurance subsidiaries expect their ultimate liability to be. Significant periods of time often elapse from the occurrence of an insured loss to the reporting of the loss and the payment of that loss. It is possible that their ultimate liability could exceed these estimates because of the future development of known losses, the existence of losses that have occurred but are currently unreported and larger than historical settlements on pending and unreported claims. The process of estimating reserves is inherently judgmental and can be influenced by variable factors including:

- trends in claim frequency and severity;
- changes in operations;
- emerging economic and social trends;
- inflation; and
- changes in the regulatory and litigation environments.

If our insurance subsidiaries have insufficient premium rates or reserves, insurance regulatory authorities may require increases to these reserves. An increase in reserves results in an increase in losses and a reduction in net income for the period in which the deficiency in reserves exists. Accordingly, if an increase in reserves is not sufficient, it may adversely impact their business, liquidity, financial condition and results of operations.

The financial results of our insurance subsidiaries depend primarily on the ability to underwrite risks effectively and to charge adequate rates to policyholders.

The financial condition, cash flows and results of operations of our insurance subsidiaries depend on the ability to underwrite and set rates accurately for a full spectrum of risks, across a number of lines of insurance. Rate adequacy is necessary to generate

sufficient premium to pay losses, loss adjustment expenses and underwriting expenses and to earn a profit.

The ability to underwrite and set rates effectively is subject to a number of risks and uncertainties, including:

- the availability of sufficient, reliable data;
- the ability to conduct a complete and accurate analysis of available data;
- the ability to timely recognize changes in trends and to project both the severity and frequency of losses with reasonable accuracy;
- uncertainties generally inherent in estimates and assumptions;
- the ability to project changes in certain operating expense levels with reasonable certainty;
- the development, selection and application of appropriate rating formulae or other pricing methodologies;
- the use of modeling tools to assist with correctly and consistently achieving the intended results in underwriting and pricing ;
- the ability to innovate with new pricing strategies, and the success of those innovations on implementation;
- the ability to secure regulatory approval of premium rates on an adequate and timely basis;
- the ability to predict policyholder retention accurately;
- unanticipated court decisions, legislation or regulatory action;
- unanticipated changes in our claim settlement practices;
- changing driving patterns for auto exposures; changing weather patterns for property exposures;
- changes in the medical sector of the economy;
- unanticipated changes in auto repair costs, auto parts prices and used car prices;
- impact of inflation and other factors on cost of construction materials and labor;

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- the ability to monitor property concentration in catastrophe prone areas, such as hurricane, earthquake and wind/hail regions; and
- the general state of the economy in the states in which we operate.

Such risks may result in the premium rates of our insurance subsidiaries being based on inadequate or inaccurate data or inappropriate assumptions or methodologies, and may cause our estimates of future changes in the frequency or severity of claims to be incorrect. As a result, our insurance subsidiaries could underprice risks, which would negatively affect our margins, or we could overprice risks, which could reduce our volume and competitiveness. In either event, underpricing or overpricing risks could adversely impact their operating results, financial condition and cash flows.

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

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

Risks Relating to Our Class A Common Stock

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

Our Class A common stock has limited liquidity. Reported average daily trading volume in our Class A common stock for the year ended December 31, 2009 was approximately 27,000 shares. This limited liquidity subjects our shares of Class A common stock to greater price volatility.

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

Donegal Mutual's ownership of our Class A common stock and Class B common stock, certain anti-takeover provisions of our certificate of incorporation and by-laws, certain provisions of Delaware law and the insurance laws and regulations of Pennsylvania, Maryland, Iowa, Virginia, Wisconsin and Georgia could delay or prevent the removal of

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members of our board of directors and could make it more difficult for a merger, tender offer or proxy contest involving us to succeed, even if our stockholders other than Donegal Mutual believed such events were beneficial to them. These factors could also discourage a third party from attempting to acquire control of us. The classification of our board of directors could also have the effect of delaying or preventing a change in control of us.

In addition, we have 2,000,000 authorized shares of preferred stock that we could issue in one or more series without stockholder approval, to the extent permitted by applicable law, and upon such terms and conditions, and having such rights, privileges and preferences, as our board of directors may determine. Our ability to issue preferred stock could make it difficult for a third party to acquire us. We have no current plans to issue any preferred stock.

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

Item 1B. Unresolved Staff Comments.

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

Item 2. Properties.

We and our insurance subsidiaries share administrative headquarters with Donegal Mutual in a building in Marietta, Pennsylvania owned by Donegal Mutual. Donegal Mutual charges us and our insurance subsidiaries for an appropriate portion of the building expenses under an inter-company allocation agreement. The Marietta headquarters has approximately 230,000 square feet of office space. Southern owns a facility of approximately 10,000 square feet in Glen Allen, Virginia. Le Mars owns a facility of approximately 25,500 square feet in Le Mars, Iowa, the Peninsula Companies own a facility of approximately 14,600 square feet in Salisbury, Maryland and Sheboygan owns a facility of approximately 8,800 square feet in Sheboygan Falls, Wisconsin.

Item 3. Legal Proceedings.

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

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Item 4. Reserved.

Not applicable.

Executive Officers of the Company.

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

<u>Name</u>	<u>Age</u>	<u>Position</u>
Donald H. Nikolaus	67	President and Chief Executive Officer of Donegal Mutual since 1981; President and Chief Executive Officer of us since 1986.
Robert G. Shenk	56	Senior Vice President, Claims, of Donegal Mutual and us since 1997; other positions from 1986 to 1997.
Cyril J. Greenya	65	Senior Vice President and Chief Underwriting Officer, of Donegal Mutual and us since 2005, Senior Vice President, Underwriting of Donegal Mutual from 1997 to 2005; other positions from 1986 to 2005.
Daniel J. Wagner	49	Senior Vice President and Treasurer of Donegal Mutual and us since 2005; Vice President and Treasurer of Donegal Mutual and us from 2000 to 2005; other positions from 1993 to 2005.
Jeffrey D. Miller	45	Senior Vice President and Chief Financial Officer of Donegal Mutual and us since 2005; Vice President and Controller of Donegal Mutual and us from 2000 to 2005; other positions from 1995 to 2005.

PART II

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

We incorporate the response to this Item in part by reference to page 40 of our Annual Report to Stockholders for the year ended December 31, 2009, or 2009 Annual Report. Our 2009 Annual Report is included as Exhibit (13) to this Form 10-K Report.

As of February 26, 2010, we had approximately 1,229 holders of record of our Class A common stock and approximately 418 holders of record of our Class B common stock.

We declared dividends of \$0.42 per share on our Class A common stock and \$0.37 per share on our Class B common stock in 2008 and \$0.45 per share on our Class A common stock and \$0.40 per share on our Class B common stock in 2009.

Between October 1, 2009 and December 31, 2009, we and Donegal Mutual purchased shares of our Class A common stock and Class B common stock as set forth in the table below.

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans of Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs ⁽¹⁾
Month #1 October 1-31, 2009	Class A — — Class B — —	Class A — \$— Class B — \$—	Class A — — Class B — —	
Month #2 November 1-30, 2009	Class A — 12,900 Class B — —	Class A — \$15.10 Class B — \$—	Class A — 12,900 Class B — —	
Month #3 December 1-31, 2009	Class A — — Class B — —	Class A — \$— Class B — \$—	Class A — — Class B — —	
Total	Class A — 12,900 Class B — —	Class A — \$15.10 Class B — \$—	Class A — 12,900 Class B — —	

(1) We announced on February 23, 2009 that we will purchase up to 300,000 shares of Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We have 292,331 additional shares of Class A common stock available for purchase under this program.

Our performance graph is included on page 39 of our 2009 Annual Report.

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Item 6. Selected Financial Data.

We incorporate the response to this Item by reference to page 6 of our 2009 Annual Report.

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

We incorporate the response to this Item by reference to pages 8 through 16 of our 2009 Annual Report.

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

Our insurance subsidiaries are exposed to the impact of changes in interest rates, changes in fair values of investments and credit risk because each them maintains a substantial investment portfolio in relation to its total assets.

In the normal course of business, we and our insurance subsidiaries employ established policies and procedures to manage and mitigate exposure to changes in interest rates, fluctuations in the fair market value of debt and equity securities and credit risk.

Interest Rate Risk

Our insurance subsidiaries monitor interest rate exposure through regular reviews of their respective asset and liability positions. Our insurance subsidiaries regularly monitor their cash flow estimates and the impact of interest rate fluctuations on their investment portfolio. Our insurance subsidiaries generally do not hedge their exposure to interest rate risk because each of them has the capacity to, and does, hold fixed-maturity investments to maturity.

The following table presents the principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates of our insurance subsidiaries:

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(amounts in thousands)	As of December 31, 2009	
	Principal cash flows	Weighted-average interest rate
<i>Fixed maturities and short-term investments:</i>		
2010	\$ 74,981	1.4%
2011	15,457	4.3
2012	20,476	3.3
2013	20,220	4.2
2014	26,965	4.1
Thereafter	479,472	4.4
Total	<u>\$ 637,571</u>	
Market value	<u>\$ 650,810</u>	
<i>Debt:</i>		
Thereafter	\$ 15,465	4.3%
Total	<u>\$ 15,465</u>	
Fair Value	<u>\$ 15,465</u>	

The actual cash flows of our insurance subsidiaries and Donegal Mutual from investments may differ from those indicated above because of calls and prepayments.

Equity Price Risk

Our insurance subsidiaries carry their portfolios of marketable equity securities on their consolidated balance sheets at estimated fair value. These securities have exposure to equity price risk. We define equity price risk as the risk of potential loss in estimated fair value resulting from an adverse change in prices. Our insurance subsidiaries seek to mitigate equity price risk and exposure by earning competitive relative returns on diverse portfolios of high-quality and liquid securities.

Credit Risk

The fixed-maturity securities portfolios our insurance subsidiaries maintain and, to a lesser extent, their short-term investments of our insurance subsidiaries are subject to credit risk. We define credit risk as the potential loss in market value resulting from adverse changes in a borrower's ability to repay its debt. Our insurance subsidiaries seek to manage this risk through pre-investment underwriting analysis and regular reviews by our investment staff. Each of our insurance subsidiaries seeks to limit its credit risk by limiting the amount of its fixed-maturity investments in the securities of any one issuer.

Our insurance subsidiaries provide property and casualty insurance coverages through independent insurance agencies located throughout the states in which Donegal Mutual and our insurance subsidiaries conduct business. Our insurance subsidiaries bill the majority of this business directly to the policyholder, although our insurance subsidiaries bill

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a portion of their commercial business through the agents of our insurance subsidiaries. Our insurance subsidiaries who extend credit to agents in the normal course of their business.

Our insurance subsidiaries place reinsurance with Donegal Mutual and with major unaffiliated authorized reinsurers. Although our insurance subsidiaries as a matter of law retain ultimate responsibility to our policyholders if a reinsurer fails for any reason to pay an insurance risk we have ceded, we do not regard this legal conclusion as a material risk because each of our insurance subsidiaries has an A.M. Best rating of A.

Item 8. Financial Statements and Supplementary Data.

We incorporate the response to this Item by reference to pages 17 through 35 of our 2009 Annual Report.

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

None.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2009 covered by this Form 10-K Report. Based on such evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of December 31, 2009, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information we are required to disclose in the reports that we file or submit under the Exchange Act and our disclosure controls and procedures are also effective to ensure that information we disclose in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, to allow timely decisions regarding required disclosure.

Internal Control over Financial Reporting

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we include a report of our management's assessment of the design and effectiveness of our internal control over financial reporting as part of our 2009 Annual Report. KPMG LLP, an independent registered public accounting firm, audited the effectiveness of our internal control over financial reporting as of December 31, 2009 based on criteria established by Internal Control —

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Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. We include the report of KPMG LLP dated March 11, 2010 as part of our 2009 Annual Report.

Changes in Internal Control over Financial Reporting

We have not changed our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2009 that have materially affected, or are reasonably likely to affect materially, our internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

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

We respond to this Item by reference to our proxy statement, or the Proxy Statement, we will file with respect to the annual meeting of our stockholders that we will hold on April 15, 2010. We respond to this Item with respect to our executive officers by reference to Part I of this Form 10-K Report.

We incorporate the full text of our Code of Business Conduct and Ethics by reference to Exhibit 15 to this Form 10-K Report.

Item 11. Executive Compensation.

We incorporate the response to this Item by reference to our proxy statement filed with the SEC relating to our annual meeting of stockholders to be held April 15, 2010. Neither the Report of our Compensation Committee nor the Report of our Audit Committee is deemed filed with the SEC or deemed incorporated by reference into any filing we make under the Securities Act or the Exchange Act, except to the extent we specifically incorporate it by reference.

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

We respond to this Item by reference to our Proxy Statement.

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

We respond to this Item by reference to our Proxy Statement.

Item 14. Principal Accountant Fees and Services.

We respond to this Item by reference to our Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedule.

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

(a) Consolidated Financial Statements

	<u>Page*</u>
Reports of Independent Registered Public Accounting Firm	36, 38
Donegal Group Inc. and Subsidiaries:	
Consolidated Balance Sheets as of December 31, 2009 and 2008	17
Consolidated Statements of Income and Comprehensive Income for each of the years in the three-year period ended December 31, 2009, 2008 and 2007	18
Consolidated Statements of Stockholders' Equity for each of the years in the three-year period ended December 31, 2009, 2008 and 2007	19
Consolidated Statements of Cash Flows for each of the years in the three-year period ended December 31, 2009, 2008 and 2007	20
Notes to Consolidated Financial Statements	21
Report and Consent of Independent Registered Public Accounting Firm	Exhibit 23
(b) Financial Statement Schedule	

Page

Donegal Group Inc. and Subsidiaries

Schedule III — Supplementary Insurance Information

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

* Refers to pages of our 2009 Annual Report to Stockholders. We incorporate by reference to pages 17 through 38 of our 2009 Annual Report, our Consolidated Financial Statements, Notes to Consolidated Financial Statements, Report of Independent Registered Public Accounting Firm on consolidated financial statements, Management's Report on

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Internal Control over Financial Reporting and Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting. With the exception of the portions of our 2009 Annual Report in this Item and Items 5, 6, 7 and 8 of this Form 10-K Report, our 2009 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 Exchange Act.

(c) Exhibits

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

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

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

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<u>Exhibit No.</u>	<u>Description of Exhibits</u>	<u>Reference</u>
(10)(EE)	Plan of Conversion of Sheboygan Falls Mutual Insurance Company adopted October 14, 2008.	(v)
(10)(FF)	Surplus Note Purchase Agreement dated as of September 8, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	Filed herewith
(10)(GG)	Quota-share Reinsurance Agreement dated as of October 30, 2009 but effective as of 11:59 p.m. on October 31, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	Filed herewith
(10)(HH)	Services and Affiliation Agreement dated as of October 30, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	Filed herewith
(10)(II)	Technology License Agreement dated as of October 30, 2009 between Donegal Mutual Insurance Company and Southern Mutual Insurance Company.	Filed herewith
(10)(JJ)	Amended and Restated Proportional Reinsurance Agreement dated March 1, 2010 between Donegal Mutual Insurance Company and Atlantic States Insurance Company.	Filed herewith
(13)	2009 Annual Report to Stockholders (electronic filing contains only those portions incorporated by reference into this Form 10-K Report).	Filed herewith
(14)	Code of Business Conduct and Ethics	(o)
(21)	Subsidiaries of Registrant.	Filed herewith
(23)	Report and Consent of Independent Registered Public Accounting Firm	Filed herewith
(31.1)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Executive Officer	Filed herewith
(31.2)	Rule 13a-14(a)/15(d)-14(a) Certification of Chief Financial Officer	Filed herewith

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<u>Exhibit No.</u>	<u>Description of Exhibits</u>	<u>Reference</u>
(32.1)	Section 1350 Certification of Chief Executive Officer	Filed herewith
(32.2)	Section 1350 Certification of Chief Financial Officer	Filed herewith

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- (a) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-3 Registration Statement No. 333-59828 filed April 30, 2001.
- (b) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2001.
- (c) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 2000.
- (d) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-8 Registration Statement No. 333-62974 filed June 14, 2001.
- (e) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-2 Registration Statement No. 333-63102 declared effective February 8, 2002.
- (f) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1999.
- (g) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1996.
- (h) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form S-1 Registration Statement No. 33-8533 declared effective October 29, 1986.
- (i) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1988.
- (j) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Report for the year ended December 31, 1992.
- (k) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 21, 1995.
- (l) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated May 31, 2000.
- (m) Such exhibit is hereby incorporated by reference to the like-described exhibits in

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Registrant's Form 8-K Report dated November 3, 2003.

- (n) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 1, 2003.
- (o) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Annual Report for the year ended December 31, 2003.
- (p) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated October 23, 2006.
- (q) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-Q Quarterly Report for the quarter ended September 30, 2006.
- (r) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 8-K Report dated December 22, 2006.
- (s) Such exhibit is hereby incorporated by reference to the like-numbered exhibit in Registrant's Form 8-K Report dated April 20, 2007.
- (t) Such exhibit is hereby incorporated by reference to the like-numbered exhibit in Registrant's Form 8-K Report dated February 13, 2008.
- (u) Such exhibit is hereby incorporated by reference to the description of such plan in Registrant's definitive proxy statement for its Annual Meeting of Stockholders to be held on April 15, 2010.
- (v) Such exhibit is hereby incorporated by reference to the like-described exhibit in Registrant's Form 10-K Annual Report for the year ended December 31, 2008.

SIGNATURES

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

DONEGAL GROUP INC.

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

Date: March 11, 2010

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

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Donald H. Nikolaus</u> Donald H. Nikolaus	President and a Director (principal executive officer)	March 11, 2010
<u>/s/ Jeffrey D. Miller</u> Jeffrey D. Miller	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	March 11, 2010
<u>/s/ Robert S. Bolinger</u> Robert S. Bolinger	Director	March 11, 2010
<u>/s/ Philip A. Garcia</u> Philip A. Garcia	Director	March 11, 2010

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<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Patricia A. Gilmartin</u> Patricia A. Gilmartin	Director	March 11, 2010
<u>/s/ Philip H. Glatfelter, II</u> Philip H. Glatfelter, II	Director	March 11, 2010
<u>/s/ Kevin M. Kraft, Sr.</u> Kevin M. Kraft, Sr.	Director	March 11, 2010
<u>/s/ John J. Lyons</u> John J. Lyons	Director	March 11, 2010
<u>/s/ Jon M. Mahan</u> Jon M. Mahan	Director	March 11, 2010
<u>/s/ S. Trezevant Moore, Jr.</u> S. Trezevant Moore, Jr.	Director	March 11, 2010
<u>R. Richard Sherbahn</u> R. Richard Sherbahn	Director	March 11, 2010
<u>/s/ Richard D. Wampler, II</u> Richard D. Wampler, II	Director	March 11, 2010

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

Years Ended December 31, 2009, 2008 and 2007

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, 2009						
Personal lines	\$241,844	\$ —	\$178,040	\$ 41,071	\$ 34,634	\$252,487
Commercial lines	113,181	—	72,795	19,221	16,209	110,742
Investments	—	20,631	—	—	—	—
	<u>\$355,025</u>	<u>\$ 20,631</u>	<u>\$250,835</u>	<u>\$ 60,292</u>	<u>\$ 50,843</u>	<u>\$363,229</u>
Year Ended December 31, 2008						
Personal lines	\$225,024	\$ —	\$155,573	\$ 37,821	\$ 34,482	\$239,540
Commercial lines	121,551	—	68,728	20,429	18,626	125,401
Investments	—	22,756	—	—	—	—
	<u>\$346,575</u>	<u>\$ 22,756</u>	<u>\$224,301</u>	<u>\$ 58,250</u>	<u>\$ 53,108</u>	<u>\$364,941</u>
Year Ended December 31, 2007						
Personal lines	\$196,429	\$ —	\$124,602	\$ 32,438	\$ 33,402	\$202,353
Commercial lines	113,642	—	53,182	18,767	19,324	111,336
Investments	—	22,785	—	—	—	—
	<u>\$310,071</u>	<u>\$ 22,785</u>	<u>\$177,784</u>	<u>\$ 51,205</u>	<u>\$ 52,726</u>	<u>\$313,689</u>

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

Segment	At December 31,			
	Deferred Policy Acquisition Costs	Liability For Losses And Loss Expenses	Unearned Premiums	Other Policy Claims and Benefits Payable
2009				
Personal lines	\$ 22,925	\$130,745	\$168,791	\$ —
Commercial lines	9,919	132,854	73,030	—
Investments	—	—	—	—
	<u>\$ 32,844</u>	<u>\$263,599</u>	<u>\$241,821</u>	<u>\$ —</u>
2008				
Personal lines	\$ 19,468	\$114,149	\$150,920	\$ —
Commercial lines	10,073	125,660	78,094	—
Investments	—	—	—	—
	<u>\$ 29,541</u>	<u>\$239,809</u>	<u>\$229,014</u>	<u>\$ —</u>

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

SURPLUS NOTE PURCHASE AGREEMENT
Between
DONEGAL MUTUAL INSURANCE COMPANY
and
SOUTHERN MUTUAL INSURANCE COMPANY
DATED AS OF SEPTEMBER 8, 2009

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SURPLUS NOTE PURCHASE AGREEMENT

THIS SURPLUS NOTE PURCHASE AGREEMENT (this "Agreement") made as of this 8th day of September, 2009 between DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company ("Donegal Mutual") and SOUTHERN MUTUAL INSURANCE COMPANY, a Georgia mutual fire insurance company ("Southern Mutual").

WITNESSETH:

WHEREAS, Southern Mutual proposes to issue a surplus note (the "Surplus Note"), the repayment of which would be subordinated to the claims of policyholders of Southern Mutual and otherwise be in compliance with applicable provisions of the Georgia Insurance Code and the regulations of the Commissioner of Insurance of the State of Georgia in the principal amount of Two Million Five Hundred Thousand Dollars (\$2,500,000) in substantially the form of Appendix A;

WHEREAS, Donegal Mutual proposes to purchase the Surplus Note;

WHEREAS, Donegal Mutual and Southern Mutual propose that Southern Mutual will (i) make certain changes in the composition of the Board of Directors of Southern Mutual in connection with the transactions contemplated by this Agreement, (ii) enter into employment agreements with certain of its executive officers in substantially the form of Appendix C and (iii) reconstitute its Board of Directors as provided in this Agreement;

WHEREAS, Donegal Mutual and Southern Mutual propose that Donegal Mutual and Southern Mutual enter into: (i) a Services Agreement in substantially the form of Appendix B whereby Donegal Mutual will provide the services specified therein to Southern Mutual in accordance with the terms of such Services Agreement, (ii) a Technology License Agreement in substantially the form of Appendix D whereby Donegal Mutual will license certain of its computer applications and systems to Southern Mutual in accordance with the terms of such Technology License Agreement and (iii) a Quota Share Reinsurance Agreement in substantially the form of Appendix E, whereby Southern Mutual will cede up to 100% of its net written premiums to Donegal Mutual in accordance with the terms of such Quota Share Reinsurance Agreement but Southern Mutual shall retain sole responsibility for all of its other liabilities;

WHEREAS, the Board of Directors of Donegal Mutual has approved this Agreement, the form of Surplus Note Donegal Mutual will purchase, the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement by resolutions duly adopted; and

WHEREAS, the Board of Directors of Southern Mutual has approved this Agreement, the Surplus Note, the Services Agreement, the Employment Agreements, the Technology License Agreement and the Quota Share Reinsurance Agreement by resolutions duly adopted;

NOW, THEREFORE, in consideration of the mutual covenants set forth in this Agreement and the Ancillary Agreements, and intending to be legally bound hereby, Donegal Mutual and Southern Mutual agree as follows:

ARTICLE I
DEFINITIONS

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

“Advisory Board” shall have the meaning set forth in Section 5.10.

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

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

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

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

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

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

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

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

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

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

“Confidentiality Agreement” shall mean the Confidentiality Agreement between Southern Mutual and Donegal Mutual dated as of May 29, 2009.

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

“Disclosure Schedules” shall mean the Disclosure Schedules of Southern Mutual attached to this Agreement.

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

“Employment Agreements” shall mean the Employment Agreements to be entered into between Southern Mutual and each of Allen R. Green, W. Daniel Delamater, Martin E. Webb and Kimberly L. McClain, in substantially the form of Appendix C.

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

“Environmental Claim” shall mean any written notice by a Person alleging actual or potential Liability, including, without limitation, potential Liability for any investigatory cost, cleanup cost, governmental response cost, natural resources damage, property damage, personal injury or penalty, arising out of, based on or resulting from (a) the presence, transport, disposal, discharge or release, of any Hazardous Materials at any location, whether

or not owned by Southern Mutual, as the case may be, or (b) circumstances forming the basis of any violation or alleged violation of any Environmental Law.

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

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

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

“Georgia Department” shall mean the Department of Insurance of the State of Georgia.

“Georgia Insurance Code” shall mean Title 33 of the Official Code of Georgia Annotated, as amended, and the regulations promulgated thereunder.

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

“Hazardous Materials” shall mean any (i) “hazardous substance,” “pollutants,” or “containment” as defined in Sections 101(14) and (33) of the United States Comprehensive Environmental Response, Compensation and Liability Act, as amended (“CERCLA”) or the regulations issued pursuant to Section 102 of CERCLA, including any element, compound, mixture, solution or substance that is or may be designated pursuant to Section 102 of CERCLA; (ii) substance that is or may be designated pursuant to Section 311(b)(2)(A) of the Federal Water Pollution Control Act, as amended (“FWCPA”); (iii) hazardous waste having the characteristics identified under or listed pursuant to Section 3001 of the Resource Conservation and Recovery Act, as amended (“RCRA”) or having the characteristics that may subsequently be considered under RCRA to constitute a hazardous waste; (iv) substance containing petroleum, as that term is defined in Section 9001(8) of RCRA; (v) toxic pollutant that is or may be listed under Section 307(a) of FWCPA; (vi) hazardous air pollutant that is or may be listed under Section 112 of the Clean Air Act, as amended; (vii) imminently hazardous chemical substance or mixture with respect to which action has been or may be taken pursuant to Section 7 of the Toxic Substance Control Act, as amended; (viii) source, special nuclear or by-product material as defined by the Atomic Energy Act of 1954, as amended; (ix) asbestos-containing material, or urea formaldehyde or material that contains it;

(x) waste oil and other petroleum products and (xi) any other toxic materials, contaminants or hazardous substances or wastes pursuant to any Environmental Law.

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

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

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

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

“Investment Assets” shall mean bonds, notes, debentures, mortgage loans, collateral loans and all other instruments of indebtedness, stocks, partnership interests and other equity interests, real estate and leasehold and other interests therein, certificates issued by or interests in trusts, cash on hand and on deposit, personal property and interests therein and all other Assets acquired for investment purposes.

“IRS” shall mean the Internal Revenue Service.

"Knowledge" as to Southern Mutual shall mean the knowledge of Allen R. Green, W. Daniel Delamater, Martin E. Webb or Kimberly L. McClain after due inquiry. "Knowledge" as to Donegal Mutual shall mean the knowledge of Donald H. Nikolaus, Jeffrey D. Miller or Daniel J. Wagner after due inquiry.

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

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

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

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

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

"Material Adverse Effect" means, with respect to Southern Mutual or Donegal Mutual, any fact, event, circumstance, change, condition or effect that (i) has been, or could reasonably be expected to be, material and adverse to the assets, liabilities, properties, financial position, results of operations, cash flows or business of Southern Mutual or Donegal Mutual and its subsidiaries taken as a whole or (ii) has materially impaired, or could reasonably be expected to impair materially, the ability of Southern Mutual or Donegal Mutual to perform their respective obligations under this Agreement or otherwise materially affect the consummation of the transactions this Agreement contemplates; provided, however, that Material Adverse Effect shall not be deemed to include the impact of (a) changes after the date of this Agreement in SAP, (b) any action or omission of Southern Mutual or Donegal Mutual with the prior consent of the other or as otherwise contemplated by this Agreement in connection with the consummation of the transactions this Agreement contemplates, (c) changes after the date of this Agreement in laws, (d) changes in general economic conditions that did not disproportionately adversely affect Southern Mutual, (e) reasonable expenses, including the retention of legal advisors, in connection with the negotiation, execution and delivery of this Agreement and the consummation of the transactions this Agreement contemplates and (f) the financial condition or the results of operations of Southern Mutual for the six months ended June 30, 2009 and the results of operations or financial condition of Southern Mutual for the period July 1, 2009 through the Closing Date.

“Member” shall mean a policyholder of Southern Mutual other than a policyholder of a reinsurance contract.

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

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

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

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

“Permits” shall have the meaning set forth in Section 3.11(d).

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

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

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

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

“Quota Share Reinsurance Agreement” shall mean the Quota Share Reinsurance Agreement between Donegal Mutual and Southern Mutual in substantially the form of Appendix E.

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

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

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

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

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

“Southern Mutual Financial Statements” shall have the meaning set forth in Section 3.5.

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

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

“Surplus Note” shall mean the Surplus Note to be issued by Southern Mutual to Donegal Mutual in substantially the form of Appendix A.

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

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

"Technology License Agreement" shall mean the Technology License Agreement between Donegal Mutual and Southern Mutual in substantially the form of Appendix D.

ARTICLE II

SALE AND PURCHASE OF SURPLUS NOTE

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

2.2 Payment of Purchase Price and Delivery of Surplus Note. The purchase price of the Surplus Note shall be Two Million Five Hundred Thousand Dollars (\$2,500,000). Donegal Mutual will pay the entire purchase price of the Surplus Note in cash to Southern Mutual on the Closing Date against delivery of the executed Surplus Note by Southern Mutual to Donegal Mutual.

2.3 Closing Date.

(a) The transactions contemplated by this Agreement shall be consummated (the "Closing") at 10:00 a.m. on October 31, 2009 or within five business days following the date on which the Commissioner has approved the change of control described in Donegal Mutual's Form A Statement if such approval has not been received by October 31, 2009 (the "Closing Date"), provided that all of the conditions set forth in Article VI shall have been fulfilled not later than the Closing Date. Unless otherwise mutually agreed by Donegal Mutual and Southern Mutual, the Closing shall be held at the offices of Duane Morris LLP, Atlantic Center Plaza, Suite 700, 1180 West Peachtree Street NW, Atlanta, GA 30309-3448 on the Closing Date.

(b) At the Closing, Southern Mutual shall deliver to Donegal Mutual (i) copies of each resolution adopted by the Board of Directors of Southern Mutual approving and adopting this Agreement, the Surplus Note, the Services Agreement, the Employment Agreements, the Technology License Agreement and the Quota Share Reinsurance Agreement and authorizing the consummation of the transactions contemplated hereby and thereby, certified by the Secretary of Southern Mutual that each such resolution is then in full force and effect and without amendment; (ii) any Officers' Certificate specified in Section 6.2 duly executed by the President of Southern Mutual; (iii) the Services Agreement duly executed by Southern Mutual; (iv) the Technology License Agreement duly executed by Southern Mutual; (v) the Quota Share Reinsurance Agreement duly executed by Southern Mutual; (vi) the Surplus Note duly executed by Southern Mutual; (vii) duly executed copies of the resignations of all but five current members of the Board of Directors of Southern

Mutual designated by Southern Mutual and evidence of the appointment of the seven designees of Donegal Mutual as members of a 12-member Southern Mutual Board of Directors as specified in Section 6.2(d); (viii) evidence of the termination of any severance or similar agreement required by Section 6.2(e), (ix) duly executed copies of the Employment Agreements as specified in Section 6.2(e), (x) appointment of the Advisory Board as provided in Section 5.10 and (xi) an officer's certificate to the effect that the Bylaws of Southern Mutual as amended effective as of the Closing Date remain in full force and effect without any change.

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

ARTICLE III

REPRESENTATIONS AND WARRANTIES OF SOUTHERN MUTUAL

As an inducement to Donegal Mutual to enter into this Agreement and to consummate the transactions contemplated herein, Southern Mutual represents and warrants to Donegal Mutual and agrees that with the exception of the matters specifically described in the Disclosure Schedules delivered by Southern Mutual to Donegal Mutual prior to the date of this Agreement:

3.1 Organization and Standing.

(a) Southern Mutual is a mutual fire insurance company duly organized, validly existing and in good standing under the laws of the State of Georgia and has the requisite corporate power and authority to conduct its business as it is currently being conducted. Southern Mutual is admitted to transact an insurance business as a foreign insurance company in South Carolina, which is the only foreign jurisdiction where Southern Mutual's failure to be admitted would have a Southern Mutual Material Adverse Effect.

(b) Southern Mutual has previously delivered accurate and complete copies of its Amended Charter as currently in effect and its Bylaws as amended to be effective as of the Closing Date to Donegal Mutual.

3.2 Subsidiaries. Southern Mutual has no subsidiaries.

3.3 Authority; No Violation.

(a) Southern Mutual has the requisite corporate power and authority to execute and deliver this Agreement and the Ancillary Documents and, subject to the receipt of the Required Filings and Approvals, to consummate the transactions contemplated hereby and thereby. The execution and delivery of this Agreement and the Ancillary Agreements have been duly approved and authorized by the Board of Directors of Southern Mutual and the consummation of the transactions contemplated hereby and thereby effective on the Closing Date.

(b) Subject to receipt of the Required Filings and Approvals, no other corporate proceedings on the part of Southern Mutual are necessary to authorize this Agreement and the Ancillary Documents and the transactions contemplated hereby and thereby.

(c) Subject to receipt of the Required Filings and Approvals, this Agreement and the Ancillary Documents, when executed and delivered by Southern Mutual and assuming the due execution thereof by the other requisite parties thereto will constitute the valid, legal and binding agreements of Southern Mutual enforceable in accordance with their respective terms, except that (i) such enforcement may be subject to bankruptcy, rehabilitation, liquidation, conservation, dissolution, insolvency, reorganization, moratorium or other similar Laws now or hereafter in effect relating to creditors' rights generally and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any Proceeding therefor may be brought.

(d) Neither the execution, delivery and performance of this Agreement or the Ancillary Documents nor the consummation of the transactions contemplated hereby or thereby, nor compliance with and the fulfillment of the terms and provisions hereof and thereof, will (i) conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under Bylaws of Southern Mutual, as amended effective as of the Closing Date, or any instrument, agreement, mortgage, judgment, Order, award, decree or other restriction to which Southern Mutual is a party or by which Southern Mutual is bound; (ii) give any party to or with rights under any such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction the right to terminate, modify or otherwise change the rights or obligations of Southern Mutual under such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction or (iii) require the approval, consent or

authorization of or any filing with or notification to any federal, state or local court or Governmental Entity, except (y) the Required Filings and Approvals and (z) any approval, consent or authorization the failure of which to obtain would not, individually or in the aggregate, have a Southern Mutual Material Adverse Effect.

3.4 Consents and Approvals of Government Entities. Other than the Required Filings and Approvals, no consent, approval, Order or authorization of, or registration, application, declaration or filing with any Governmental Entity is required with respect to Southern Mutual in connection with the execution and delivery of this Agreement and the Ancillary Documents.

3.5 Financial Statements; Examinations.

(a) Southern Mutual has furnished to Donegal Mutual the audited balance sheets of Southern Mutual as of December 31, 2006, 2007 and 2008 and the related statements of operations and of changes in financial position for the periods then ended, together with appropriate notes to such financial statements (collectively, the "Southern Mutual Financial Statements"). The Southern Mutual Financial Statements are accompanied by the reports thereon by Habib, Arogeti & Wynne, LLP, independent registered public accountants. The Southern Mutual Financial Statements are correct and complete in all material respects and fairly present the financial position of Southern Mutual as at the respective dates thereof, the results of its operations and the changes in its financial position for the respective periods covered thereby and have been prepared in conformity with SAP consistently applied throughout all periods.

(b) Each of the Annual Statements of Southern Mutual for 2006, 2007 and 2008 was in compliance in all material respects with applicable Law when filed.

(c) The most recently completed report of examination of Southern Mutual conducted by the Georgia Department was for the period set forth in Schedule 3.5(C), and a complete and correct copy of such report is attached to Schedule 3.5(C).

(d) Since the dates of all examinations referred to in Schedule 3.5(C), Southern Mutual has not been the subject of further examination by any insurance Governmental Entity, and Southern Mutual is not currently undergoing examination by any insurance Governmental Entity.

(e) Southern Mutual has also furnished to Donegal Mutual its unaudited financial statements for the six months ended June 30, 2009. Such financial statements fairly present the financial position of Southern Mutual as of June 30, 2009 and the results of its operations for the six months then ended and have been prepared in conformity with SAP as used in the preparation of the Southern Mutual Financial Statements.

(f) Schedule 3.5(F) sets forth a correct and complete list of all (i) accounts, borrowing resolutions and deposit boxes maintained by Southern Mutual at any bank or other financial institution, (ii) the names of the persons authorized to sign or otherwise act for Southern Mutual with respect thereto and (iii) powers of attorney for Southern Mutual with respect thereto.

3.6 Material Changes Since December 31, 2008. Since December 31, 2008, Southern Mutual has operated its business in the Ordinary Course of Business and, whether or not in the Ordinary Course of Business of Southern Mutual, other than as disclosed in this Agreement or the Schedules to this Agreement, there has not been, occurred or arisen (i) any material adverse change in the Condition of Southern Mutual from that shown on the balance sheet of Southern Mutual as of December 31, 2008 referred to in Section 3.5; (ii) any damage or destruction in the nature of a casualty loss, whether covered by insurance or not, to any Asset that is material to the financial condition, operations or business of Southern Mutual; (iii) any material increase in any employee benefit plan listed in Section 3.19; (iv) any amendment or termination of any agreement, or cancellation or reduction of any debt owing to Southern Mutual or waiver or relinquishment of any right of material value to Southern Mutual or (v) any other event, condition or state of facts of any character that would constitute a Southern Mutual Material Adverse Effect.

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

3.8 Title to Assets. Southern Mutual has good and marketable title to all of its Assets, including the Assets reflected on the December 31, 2008 balance sheet referred to in Section 3.5 and all of the Assets thereafter acquired by it, except to the extent that such Assets have thereafter been disposed of for fair value in the Ordinary Course of Business of Southern Mutual.

3.9 Books and Records. The books of account, minute books and other records of Southern Mutual, all of which have been made available to Donegal Mutual, are complete and correct and have been maintained in accordance with sound business practices and the requirements of the Georgia Insurance Code and any other applicable Laws, including, but not limited to, the requirements of Section 13(b)(2) of the Securities Exchange Act of 1934, as amended, to the extent applicable to Southern Mutual, and Southern Mutual maintains an adequate system of internal controls. Since January 1, 2004, the minute books of Southern Mutual contain accurate and complete records of all meetings held of, and corporate action

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

3.10 Accounts Receivable. All accounts receivable reflected on the December 31, 2008 balance sheet referred to in Section 3.5 and all accounts receivable arising subsequent to such date and prior to the date of this Agreement, not collected at the date hereof, have arisen from bona fide transactions in the Ordinary Course of Business of Southern Mutual. To the Knowledge of Southern Mutual, none of such receivables is subject to counterclaims or set-offs or is in dispute and all of such accounts are good and collectible in the Ordinary Course of Business at the aggregate recorded amounts thereof, subject in each case to the allowance for possible losses shown on such balance sheet. All accounts receivable existing on the Closing Date will be good and collectible in the Ordinary Course of Business at the aggregate recorded amounts thereof, net of any applicable allowance for doubtful accounts, which allowance will be determined on a basis consistent with the basis used in determining the allowance for doubtful accounts reflected in the December 31, 2008 balance sheet referred to in Section 3.5.

3.11 Compliance with Legal Requirements; Governmental Authorizations. Schedule 3.11 contains a complete and accurate list and copy of the licenses of Southern Mutual to transact insurance in a state and each other material license, permit and other authorization held by Southern Mutual in the operation of its business. Except as set forth in Schedule 3.10:

(a) To the Knowledge of Southern Mutual, Southern Mutual is, and at all times since January 1, 2004 has been, in compliance in all material respects with the Georgia Insurance Code, and all other Laws that are applicable to it or to the conduct or operation of its business or the ownership or use of any of its Assets.

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

(c) Southern Mutual has not received, at any time since January 1, 2004, any oral or written notice or other communication from any Governmental Entity or any other Person regarding (i) any actual, alleged, possible or potential violation of, or failure to comply with, any Law in any material respect or (ii) any actual, alleged, possible or potential material obligation that may give rise on the part of Southern Mutual to undertake, or to bear all or any portion of the cost of, any material remedial action of any nature.

(d) Southern Mutual possesses all material Licenses, Permits and other authorizations necessary to own or lease and operate its properties and to conduct its business as now conducted and, to the Knowledge of Southern Mutual, each of Southern Mutual's agents is duly licensed as such. All of such Licenses, Permits and authorizations of Southern Mutual and such agents' appointments are hereinafter collectively called the "Permits." All Permits are in full force and effect and will continue in effect after the date hereof and the Closing Date without the consent, approval or act of, or the making of any filing with, any Governmental Entity other than the Required Filings and Approvals. To the Knowledge of Southern Mutual, Southern Mutual is, and at all times since January 1, 2004 has been, in material compliance with all terms and requirements of each Permit. Neither Southern Mutual nor, to the Knowledge of Southern Mutual, any of Southern Mutual's agents are in material violation of the terms of any Permit, and Southern Mutual has not received notice of any violation or claimed violation thereunder. All applications required to have been filed for the renewal of any and all Permits have been duly filed on a timely basis with the appropriate Governmental Entity, and all other filings required to have been made with such Governmental Entities with respect to the Permits have been duly made on a timely basis.

3.12 Real Property and Leases. Southern Mutual does not own any real property except as listed on Schedule 3.12(A), and, except as listed on Schedule 3.12(A), Southern Mutual is not a party to any lease or agreement under which Southern Mutual is lessee or sublessee of, or holds or operates, any real property owned by any third party. All of such leases and agreements are in full force and effect and constitute legal, valid and binding obligations of Southern Mutual, and, to the Knowledge of Southern Mutual, the other parties thereto. Southern Mutual is not in default in any material respect under any such lease or agreement nor has any event occurred that, with the passage of time or giving of notice or both would constitute such a default and Southern Mutual will not take any action or fail to take required action between the date hereof and the Closing Date that would permit any such default or event to occur. None of such leases and agreements requires the consent of any party thereto in order to undertake or consummate the transactions contemplated by this Agreement.

3.13 Insurance. Southern Mutual maintains policies of fire and casualty, product and other liability and other forms of insurance in such amounts and against such risks and losses as are adequate and reasonable for its business as currently conducted and properties and are sufficient for compliance with all Laws applicable to Southern Mutual. All such policies are valid, duly issued and enforceable in accordance with their respective terms and conditions. The attached Schedule 3.13 lists all policies of insurance that are or were owned, held or maintained by or for the benefit of Southern Mutual or under which Southern Mutual is or was a named insured from January 1, 2006 to the date hereof, including policy numbers, nature of coverage, limits, deductibles, carriers, premiums and effective and termination dates, under which Southern Mutual has any remaining coverage. To the Knowledge of

Southern Mutual, Southern Mutual has complied with each of such policies and has not failed to give any notice or present any known claim thereunder. Southern Mutual will keep such insurance in full force and effect through the Closing Date. Southern Mutual has not received, and, to the Knowledge of Southern Mutual, no event or omission has occurred that may cause it to receive, notice that any such policies will be cancelled or will be reduced in amount or scope. Southern Mutual has delivered true and complete copies of all such policies to Donegal Mutual.

3.14 Conduct of Business.

(a) Schedule 3.14 lists all claims arising in other than the Ordinary Course of Business of Southern Mutual that are pending or, to the Knowledge of Southern Mutual, threatened against Southern Mutual and correctly sets forth the data reflected therein, including the insurance carrier to which the claim has been reported. No insurance carrier listed therein has denied coverage of any claim listed opposite its name or accepted investigation of any such loss or defense of any such claim under a reservation of rights.

(b) The aggregate actuarial reserves and other actuarial amounts held in respect of Liabilities with respect to Insurance Contracts of Southern Mutual as established or reflected in the December 31, 2008 Annual Statement of Southern Mutual and in the Southern Mutual Financial Statements as of December 31, 2008: (i) were determined in accordance with sound actuarial standards consistently applied, (ii) were fairly stated in accordance with sound actuarial principles, (iii) were based on actuarial assumptions that are in accordance with those specified in the related Insurance Contracts, (iv) met meet the requirements of the insurance Laws of the applicable jurisdiction in all material respects and (v) to the Knowledge of Southern Mutual, were adequate to cover the total amount of all reasonably anticipated matured and unmatured Liabilities of Southern Mutual under all outstanding Insurance Contracts pursuant to which Southern Mutual has any Liability. For purposes of clause (v) above, (x) the adequacy of reserves shall be determined only on the basis of facts and circumstances known based on procedures consistently applied by Southern Mutual in connection with assessing the adequacy of reserves from time to time by Southern Mutual as at the date hereof and (y) the fact that reserves covered by any such representation may be subsequently adjusted at times and under circumstances consistent with Southern Mutual's ordinary practice of periodically reassessing the adequacy of its reserves shall not be used to support any claim regarding the accuracy of such representation.

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

3.15 No Undisclosed Material Liabilities. Southern Mutual is not subject to any material Liability, including, to the Knowledge of Southern Mutual, unasserted claims, absolute or contingent, that is not shown or that is in excess of amounts shown or reserved for in the December 31, 2008 balance sheet referred to in Section 3.5, other than Liabilities of the same nature as those set forth in such balance sheet and reasonably incurred in the Ordinary Course of Business of Southern Mutual after December 31, 2008.

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

3.17 Tax Liabilities. The amounts reflected as liabilities for Taxes on the December 31, 2008 balance sheet referred to in Section 3.5 are sufficient for the payment of all Taxes of Southern Mutual accrued for or applicable to the period ended on such balance sheet date and all years and periods prior thereto. All Tax Returns that are required to be filed by or in respect of Southern Mutual up to and including the date hereof have been filed and all Taxes, including any interest and penalties thereon, which have become due pursuant to such Returns or pursuant to any assessment have been paid and no extension of the time for filing of any such return is presently in effect. All such Returns that have been filed or will be filed by or in respect of Southern Mutual for any period ending on or before the Closing Date are or will be true and correct. There exists no proposed assessment against Southern Mutual. No consent to the application of Section 341(f)(2) of the Code has been filed with respect to any Southern Mutual Property. Southern Mutual has withheld and paid all Taxes required to have been withheld and paid in connection with amounts paid or owing to any employee, independent contractor or other third party. No claim has ever been made by a Governmental Entity in a jurisdiction where Southern Mutual does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. Southern Mutual has delivered to Donegal Mutual correct and complete copies of all federal, state and local Tax Returns, examination reports and statements of deficiencies assessed against or agreed to by Southern Mutual since January 1, 2004. The federal Tax Returns for Southern Mutual have never been examined by the IRS, and the applicable statute of limitations relating thereto has expired for the tax year ended December 31, 2004 and all prior periods.

3.18 Contracts. Except as disclosed on Schedule 3.18, Southern Mutual is not a party to (i) any contract for the purchase or sale of real property to or from any third party; (ii) any contract for the lease or sublease of personal property from or to any third party that

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

3.19 Employee Agreements. Schedule 3.19 lists all plans, contracts and arrangements, oral or written, including but not limited to, union contracts, employee benefit plans, deferred compensation agreements, split dollar agreements, employment agreements, consulting agreements, confidentiality agreements, non-competition agreements or other agreements with any of Southern Mutual's employees, whereunder Southern Mutual has any obligation, other than obligations to make current wage or salary payments terminable on notice of 30 days or less, to or on behalf of its officers, employees or their beneficiaries or whereunder any of such persons owes money to Southern Mutual.

3.20 Employee Relations. Southern Mutual has not engaged in any unfair labor practice, unlawful employment practice or unlawful discriminatory practice in the conduct of its business. To the Knowledge of Southern Mutual, Southern Mutual has complied in all material respects with all applicable Laws relating to wages, hours and collective bargaining and has withheld all amounts required by agreement to be withheld from the wages or salaries of employees. The relations of Southern Mutual with its employees are satisfactory, and Southern Mutual is not a party to or affected by or threatened with, or to the Knowledge of Southern Mutual in danger of, being a party to or affected by, any labor dispute that materially interferes or would materially interfere with the conduct of its business. Schedule 3.20 sets forth the name and total annual compensation, including bonuses, payable to each of the officers, directors and employees of Southern Mutual whose total annual compensation, including bonuses, during the year ended December 31, 2008 exceeded the sum of \$75,000. Since December 31, 2008, there has been no material increase in the compensation payable to any of such officers, directors or employees, except as set forth in Schedule 3.20.

3.21 Employee Retirement Income Security Act.

(a) Schedule 3.19 contains a list of any "employee benefit plan" within the meaning of Section 3(3) of ERISA established or maintained by Southern Mutual or to which Southern Mutual has made any contribution. Southern Mutual is not required, and was not required within the immediately preceding five years, to make any contribution to any "multiemployer plan" within the meaning of Section 3(37) of ERISA. Southern Mutual has no liability in respect of any employee benefit plan established or maintained or to which contributions are or were made by it to the PBGC or to any beneficiary of such plans. Southern Mutual has timely filed all required reports and descriptions, including Form 5500 Annual Reports, summary annual reports, PBGC-1's and summary plan descriptions, and distributed such documents appropriately with respect to each such employee benefit plan. Southern Mutual has met the requirements of COBRA with respect to each such employee benefit plan that is an Employee Welfare Plan.

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

described in Sections 406 and 408 of ERISA or Section 4975 of the Code. No reportable event, as defined in Section 4043 of ERISA, has occurred with respect to any employee pension benefit plan maintained or contributed to by Southern Mutual or in respect of which Southern Mutual is an employer under Section 414 of the Code and none of such plans has been terminated by the plan administrator thereof or by the PBGC. To the Knowledge of Southern Mutual, none of Southern Mutual or its affiliates has incurred any liability for non-compliance with ERISA or any regulations thereunder. The original or a complete and correct copy of each plan listed in Schedule 3.19 has been delivered to Donegal Mutual.

3.22 Conflicts; Sensitive Payments. To the Knowledge of Southern Mutual, and except as set forth on Schedule 3.22, since January 1, 2004, there are (i) no material situations involving the interests of Southern Mutual or, to the Knowledge of Southern Mutual, any officer or director of Southern Mutual, that may be generally characterized as a "conflict of interest," including, but not limited to, the leasing of property to or from Southern Mutual or direct or indirect interests in the business of competitors, suppliers or customers of Southern Mutual and (ii) no situations involving illegal payments or payments of doubtful legality from corporate funds of Southern Mutual since January 1, 2004 to governmental officials or others that may be generally characterized as a "sensitive payment."

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

3.24 Trademarks and Proprietary Rights. All trademarks, trade names, copyrights and applications therefor that Southern Mutual owns or that are registered in the name of or licensed to Southern Mutual are listed and briefly described in Schedule 3.24. No proceedings have been instituted, or are pending or threatened or, to the Knowledge of Southern Mutual, contemplated that challenge the validity of the ownership by Southern Mutual of any of such trademarks, trade names, copyrights or applications. Southern Mutual has not licensed anyone to use any of the foregoing or any other technical knowhow or other proprietary rights of Southern Mutual, and Southern Mutual has no Knowledge of the infringing use if any of such trademarks and trade names or the infringement of any such copyrights by any Person. Southern Mutual is legally entitled to use all trademarks, trade names, copyrights, processes and other technical know-how and other proprietary rights now used in the conduct of its business and has not received any notice of conflict with the asserted rights of others.

3.25 Environmental Matters.

(a) Southern Mutual is, and, to the Knowledge of Southern Mutual, all Southern Mutual Property including, with respect to any Southern Mutual Property, all owners or operators thereof, are, and at all times have been in substantial compliance with all

applicable Environmental Laws. Southern Mutual has not received any communication, written or oral, that alleges that Southern Mutual or any Southern Mutual Property including, with respect to any Southern Mutual Property, any owner or operator thereof, is not in such compliance, and, to the Knowledge of Southern Mutual, there are no circumstances that may prevent or interfere with such compliance in the future.

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

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

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

(e) Without in any way limiting the generality of the foregoing, and except as set forth on Schedule 3.25(e), to the Knowledge of Southern Mutual, (i) there are no underground storage tanks and currently or formerly located on any Southern Mutual Property, (ii) there is no friable asbestos contained in or forming part of any building or structure owned or leased by Southern Mutual and (iii) no polychlorinated biphenyls are used or stored at or on any Southern Mutual Property.

3.26 Insurance Issued by Southern Mutual.

(a) Southern Mutual has provided Donegal Mutual with a list of all forms of Insurance Contracts used by Southern Mutual as of August 1, 2009, and has made available to Donegal Mutual copies of all forms of Insurance Contracts used by Southern Mutual as of August 1, 2009 that are not standard Insurance Services Office forms. Since August 1, 2009, no forms of Insurance Contracts written by Southern Mutual have been amended and no sales of any new forms of Insurance Contracts have been commenced, other than changes to forms, which changes are not, in the aggregate, material.

(b) To the Knowledge of Southern Mutual, all benefits payable on or prior to the date as of which this representation is made by Southern Mutual under Insurance Contracts have in all material respects been paid, or provision for payment thereof has been made, in accordance with the terms of the Insurance Contracts under which they arose, such payments were not delinquent and were paid, or if provision has been made will be paid, without fines or penalties, except for fines or penalties that do not exceed \$10,000, individually, or \$25,000, in the aggregate, and except for such benefits for which Southern Mutual reasonably believes there is a reasonable basis to contest payment and is taking such action.

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

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

(e) Southern Mutual has no outstanding Liability under assumed reinsurance agreements of any nature.

3.27 Health and Safety Matters.

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

(b) Without limiting the generality of the foregoing, Southern Mutual has obtained and complied with, and is in compliance with, all Permits, licenses and other authorizations that are required pursuant to the Health and Safety Requirements for the occupation of its facilities and the operation of its business, a list of all such Permits, licenses and other authorizations is included as Schedule 3.27.

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

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

3.29 Finders. Southern Mutual has not paid or become obligated to pay any fee or commission to any broker, finder or intermediary in connection with the transactions contemplated by this Agreement.

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

ARTICLE IV

REPRESENTATIONS AND WARRANTIES OF DONEGAL MUTUAL

Donegal Mutual represents and warrants to Southern Mutual as follows:

4.1 Organization and Standing.

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

(b) Donegal Mutual has previously delivered copies of its Articles of Agreement and its Amended and Restated By-laws as currently in effect to Southern Mutual, and all such copies are accurate and complete as of the date hereof.

4.2 Authority; No Violation.

(a) Donegal Mutual has the requisite corporate power and authority to execute and deliver this Agreement, the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement and to consummate the transactions contemplated hereby and thereby. The execution and delivery of this Agreement, the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement and the consummation of the transactions contemplated hereby and thereby have been duly approved and authorized by the Board of Directors of Donegal Mutual.

(b) Subject to the receipt of the Required Filings and Approvals, no other corporate proceedings on the part of Donegal Mutual are necessary to authorize this Agreement, the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement and the transactions contemplated hereby and thereby.

(c) Subject to the receipt of the Required Filings and Approvals, this Agreement and the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement when executed and delivered by Donegal Mutual and, assuming the due execution thereof by Southern Mutual, will constitute the valid, legal and binding obligations of Donegal Mutual enforceable against Donegal Mutual in accordance with their respective terms, except that (i) such enforcement may be subject to bankruptcy, rehabilitation, liquidation, conservation, dissolution, insolvency, reorganization, moratorium or other similar Laws now or hereafter in effect relating to creditors' rights generally and (ii) the remedy of specific performance and injunctive and other forms of equitable relief may be subject to equitable defenses and to the discretion of the court before which any Proceeding therefor may be brought.

(d) Neither the execution, delivery and performance of this Agreement or the Services Agreement, the Technology License Agreement or the Quota Share Reinsurance Agreement nor the consummation of the transactions contemplated hereby and thereby nor compliance with and fulfillment of the terms and provisions hereof and thereof, will (i) conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under the Articles of Agreement or the Amended and Restated By-laws of Donegal Mutual, or any instrument, agreement, mortgage, judgment Order, award, decree or other restriction to which Donegal Mutual is a party or by which Donegal Mutual is bound; (ii) give any party to or with rights under any such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction the right to terminate, modify or otherwise change the rights or obligations of Donegal Mutual under such instrument, agreement, mortgage, judgment, Order, award, decree or other restriction or (iii) require the approval, consent or authorization of or any filing with or notification to any federal, state or local court or Governmental Entity, except (y) the Required Filings and Approvals and (z) any approval, consent or authorization the failure of which to obtain would not, individually or in the aggregate, have a Donegal Mutual Material Adverse Effect.

4.3 Consents and Approvals of Government Entities. Other than the Required Filings and Approvals, no consent, approval, Order or authorization of, or registration, application, declaration or filing with any Governmental Entity is required with respect to Donegal Mutual in connection with the execution and delivery of this Agreement, the Services Agreement, the Technology License Agreement and the Quota Share Reinsurance Agreement.

4.4 Transferability. Donegal Mutual will acquire the Surplus Note for its own account, and not with a view to, and not in connection with, a public distribution or resale thereof. Without the prior approval of the Commissioner of Insurance and provided such transferee has agreed to be bound by this Section 4.4 prior to such transfer, Donegal Mutual will not transfer the Surplus Note except in a transaction registered or exempt from registration under the Securities Act or to a non-affiliate of Donegal Mutual. Southern Mutual acknowledges that Donegal Mutual's investments are at all times within its control and direction.

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

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

ARTICLE V CERTAIN COVENANTS

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

Mutual or its representatives shall affect the representations and warranties of Southern Mutual hereunder or the liability of Southern Mutual with respect thereto.

5.2 Confidential Nature of Information.

(a) Donegal Mutual and Southern Mutual agree that, in the event that the transactions contemplated by this Agreement shall not be consummated, each will treat in confidence all documents, materials and other information that it shall have obtained during the course of the negotiations leading to this Agreement, the investigation of the other party hereto and the preparation of this Agreement and other documents relating to this Agreement with the exception of any filings made by Donegal Mutual or Southern Mutual with the Georgia Department (collectively, the "Confidential Information"), and shall return to the other party all copies of the Confidential Information that have been furnished in connection therewith.

(b) In the event that a party hereto becomes legally compelled to disclose any of the Confidential Information, it shall provide the other party with reasonable notice so that it may seek a protective order or other appropriate remedy or waive compliance with the provisions of this Section 5.2. In the event that such protective order or other remedy is not obtained or that the other party waives compliance with the provisions of this Section 5.2, the first party will furnish only that portion of the Confidential Information that it is advised by opinion of counsel, which counsel shall be reasonably acceptable to the other party, is legally required and will endeavor to obtain assurance that confidential treatment will be accorded the Confidential Information so furnished.

(c) Donegal Mutual and Southern Mutual agree and acknowledge that a breach of the provisions of this Section 5.2 may cause the other party to suffer irreparable damage that could not be adequately remedied by an action at law. Accordingly, each party agrees that the other party shall have the right to seek specific performance of the provisions of this Section 5.2 to enjoin a breach or attempted breach of the provisions of this Section 5.2, such right being in addition to all other rights and remedies that are available to each party at law, in equity or otherwise. The foregoing shall be in addition to the rights and obligations under the Confidentiality Agreement.

5.3 Preserve Accuracy of Representations and Warranties.

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

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

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

5.5 Make No Material Change in Southern Mutual. Prior to the Closing Date, Southern Mutual shall not, without the prior written approval of Donegal Mutual, (i) make any material change in the business or operations of Southern Mutual except as set forth in this Agreement; (ii) make any material change in the accounting policies applied in the preparation of the financial statements referred to in Section 3.5; (iii) make any material change in the compensation of the officers, directors or key employees of Southern Mutual other than in the Ordinary Course of Business of Southern Mutual; (iv) enter into any contract, license, franchise or commitment other than in the Ordinary Course of Business of Southern Mutual or waive any rights of substantial value; (v) make any donation to any charitable, civic, educational or other eleemosynary institution in excess of donations made in comparable past periods, (vi) make any reduction in any loss expense reserve or incurred but not reported reserve prior to the Closing Date; (vii) make any change in the levels, procedures or methods employed in the setting or changing of case basis loss reserves; (viii) make any reduction in net case basis loss reserves not consistent with the levels, procedures or methods employed by Southern Mutual in the setting or changing of case basis loss reserves as in effect on the date of this Agreement and, in any event, within 10 days following any reduction in Southern Mutual's net case basis loss reserve in any one claim file in excess of \$25,000, except for a reduction occurring because a payment has been made on the reserve or because the claim has been settled and the case closed, and, in any case, Southern Mutual shall provide Donegal Mutual with a written explanation of such reduction in reasonable detail certified by Southern Mutual's President or (ix) enter into any other transaction affecting in any material respect the business of Southern Mutual other than in the Ordinary

Course of Business of Southern Mutual and in conformity with the past practices of Southern Mutual or as contemplated by this Agreement.

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

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

5.8 No Solicitation. Southern Mutual shall not, nor shall it authorize or permit any of its officers, directors or employees or any investment banker, financial advisor, attorney, accountant, actuary or other Person retained by it or on its behalf to: (a) solicit or encourage, including, without limitation, by way of furnishing information, or take any action to facilitate or pursue, any inquiries or the making of any proposal that constitutes, or may reasonably be expected to lead to, any Reorganization Proposal or (b) agree to, approve or endorse any Reorganization Proposal; provided, however, that nothing contained in this Section 5.8 shall prohibit the Board of Directors of Southern Mutual from furnishing information to, or entering into discussions or negotiations with, any person or entity that made an unsolicited bona fide proposal to acquire Southern Mutual pursuant to a Reorganization Proposal if and only to the extent that, (i) the Board of Directors of Southern Mutual determines in good faith that such action is required to comply with its fiduciary duties to its Members imposed by Law, (ii) prior to furnishing such information to, or entering into discussions or negotiations with, such person or entity, Southern Mutual provides written notice to Donegal Mutual to the effect that it is furnishing information to, or entering into discussions or negotiations with, such person or entity and (iii) Southern Mutual continues to keep Donegal Mutual informed of the status of any such discussions or negotiations. Nothing in this Section 5.8 shall (x) permit Southern Mutual to terminate this Agreement, except as specifically provided in Article VII, (y) permit Southern Mutual to enter into any agreement with respect to a Reorganization Proposal during the term of this Agreement or (z) affect any other obligation of Southern Mutual under this Agreement. Southern Mutual shall promptly advise Donegal Mutual orally and in writing of any such inquiries or proposals however preliminary and whether written or oral, and shall communicate the full and complete details of any such inquiry or proposal including, without limitation, the identity of all Persons involved. As used in this Agreement,

"Reorganization Proposal" shall mean any proposal for, or to discuss, a merger, consolidation, sale of all or substantially all of the Assets, demutualization, quota share, assumption or other assumption reinsurance arrangement or other reorganization, arrangement or business combination involving Southern Mutual or any proposal or offer for, or to discuss, the acquisition in any manner of control of a substantial portion of the Assets of or business conducted by Southern Mutual other than the transactions this Agreement contemplates.

5.9 Future Actions Regarding Southern Mutual. Donegal Mutual and Southern Mutual agree that the following undertakings with respect to certain future action relating to Southern Mutual were important inducements to the decision of Southern Mutual and Donegal Mutual to enter into this Agreement unless at least three of the Southern Mutual designees then serving on the Board of Directors of Southern Mutual vote to approve such action.

(a) Donegal Mutual agrees that it shall not, and shall use commercially reasonable efforts to ensure that its director designees do not, take any act that would have the effect of changing the status of Southern Mutual as a Georgia-domiciled mutual insurance company or change the name of Southern Mutual, demutualize Southern Mutual, redomesticate Southern Mutual or enter into a bulk reinsurance or bulk reinsurance assumption agreement or transfer all or part of Southern Mutual's business to a non-affiliate of Donegal Mutual. This covenant shall not preclude Donegal Mutual's assumption of Southern Mutual's insurance policies with and into another insurance company through one or more reinsurance agreements or Donegal Mutual's inclusion of such business in its pooling agreement with Atlantic States Insurance Company.

(b) Donegal Mutual and Southern Mutual have agreed that until the later to occur of (i) repayment of the principal amount and all accrued but unpaid interest on the Surplus Note, (ii) the termination of the Technology License Agreement in accordance with its terms and (iii) the termination of the Quota Share Reinsurance Agreement in accordance with its terms, Southern Mutual shall use its best efforts to assure that for a period of seven years from the Closing Date the Board of Directors of Southern Mutual shall consist of 12 members, five of whom shall be designees of Southern Mutual and seven of whom shall be designees of Donegal Mutual. Donegal Mutual further agrees, for a period of not less than seven years from the Closing Date, to cause its designees on the Southern Mutual's Board of Directors to nominate the initial Southern Mutual designees for election as successors to such designees upon the expiration of their respective terms. In the event a Southern Mutual designee is no longer able to serve as a director, Donegal Mutual agrees to cause its designees on the Southern Mutual Board to nominate for election by Southern Mutual's members or appoint as a successor director to fill a vacancy on the Board of Directors, as the case may be, a person who is recommended by the remaining Southern Mutual designees on the Board.

After seven years from the Closing Date, Donegal Mutual agrees to maintain an appropriate Georgia presence on the Board of Directors of Southern Mutual.

(c) For a period of seven years from the Closing Date, Donegal Mutual will not take any action to relocate or close the existing facilities of Southern Mutual in Athens, Georgia.

(d) Donegal Mutual agrees to use commercially reasonable efforts to maintain continued employment of underwriting, claims and marketing personnel at Southern Mutual's home office, with the levels of employment commensurate with the premium volume of Southern Mutual.

(e) Donegal Mutual and Southern Mutual agree to establish, within 30 days from the date of the Closing, a technology team consisting of employees of Donegal Mutual and employees of Southern Mutual. The technology team shall analyze the existing Southern Mutual computer system and determine if it would be beneficial to Southern Mutual to migrate Southern Mutual's computer system over time to Donegal Mutual's computer system. The technology team shall also analyze the adaptation of Southern Mutual's current computer system so that Southern Mutual's computer system could operate Donegal Mutual's WritePro and WriteBiz applications, all subject to the terms of the Technology License Agreement.

(f) Donegal Mutual shall develop in coordination with Southern Mutual a business plan to expand the volume of premium Donegal Mutual and Southern Mutual write in Georgia and South Carolina. The business plan shall provide that Southern Mutual will continue to be a viable and competitive market for preferred and standard personal lines and other products with an expanding agency distribution system.

(g) Southern Mutual shall preserve and keep in full force and effect its existence as a mutual fire insurance company authorized under the Laws of the State of Georgia to write the lines of business Southern Mutual is authorized to conduct on the date of this Agreement and its admission to transact an insurance business in Georgia and South Carolina;

(h) Donegal Mutual, pursuant to the Services Agreement, shall provide Southern Mutual with support and assistance in its principal business areas, including underwriting, accounting and finance, reinsurance, actuarial, claims, investments and technology;

(i) At any reasonable time and from time to time, Southern Mutual agrees to permit Donegal Mutual or any agents or representatives thereof to examine and make copies of and take abstracts from the records and books of account of, and visit the properties of, Southern Mutual during regular business hours and upon five days prior notice to

Southern Mutual, and to discuss the affairs, finances and accounts of Southern Mutual with Southern Mutual's officers;

(j) For a period of seven years from the Closing Date, all meetings of the Boards of Directors and the Advisory Board of Directors of Southern Mutual shall be held at the home office of Southern Mutual in Athens, Clarke County, Georgia, it being understood, however, that Article 3, Section 20, of Southern Mutual's Amended Bylaws permits directors to participate in a board meeting by conference telephone or other form of communication by means of which all persons participating in the meeting can hear each other and that such participation shall constitute presence in person at such meeting;

(k) Southern Mutual shall have filed the August 31, 2009 amendments to its Bylaws with the Department which amended Bylaws shall become effective as of the Closing Date; and

(l) Donegal Mutual and Southern Mutual shall not amend, repeal, change, or modify this Agreement or the Surplus Note after the Closing Date without the approval of three of the Southern mutual designees.

5.10 Advisory Board. Effective as of the Closing Date and for a period of seven years following the Closing Date, Donegal Mutual and Southern Mutual shall take all necessary action to establish an Advisory Board of Directors and appoint to the Advisory Board of Directors each current director of Southern Mutual who will not continue as a director of Southern Mutual after the Closing Date. For two years following the Closing Date, members of the Advisory Board of Directors shall be paid the same compensation as members of the Board of Directors of Southern Mutual. Thereafter, the Board of Directors of Southern Mutual shall annually establish the compensation of the members of its Advisory Board of Directors.

ARTICLE VI

CONDITIONS

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

(a) All Required Filings and Approvals required to be obtained prior to the Closing Date solely for this Agreement, the Ancillary Documents and the Amended Bylaws that will become effective as of the Closing Date and the election of designees of Donegal Mutual as a majority of the members of the Board of Directors of Southern Mutual shall have been obtained and not rescinded or adversely modified or limited as set forth in the proviso

below or, if merely required to be filed, such filings shall have been made and accepted, and all waiting periods prescribed by applicable Law shall have expired or been terminated in accordance with applicable Law; provided that such approvals shall not contain any conditions or limitations that compel or seek to compel Southern Mutual to dispose of all or any portion of the business or Assets of Southern Mutual or impose or seek to impose any limitation on the ability of Southern Mutual to conduct its business or own its Assets after the Closing Date in substantially the same manner as Southern Mutual presently conducts its business and owns its Assets;

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

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

6.2 Conditions to Obligations of Donegal Mutual. The obligation of Donegal Mutual to purchase and pay for the Surplus Note and to perform its other obligations under this Agreement to be performed on the Closing Date shall, at the option of Donegal Mutual, be subject to the satisfaction on or prior to the Closing Date, of the following conditions:

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

(b) There shall have been no material breach by Southern Mutual in the performance of any of its covenants and agreements in this Agreement, each of the representations and warranties of Southern Mutual contained in this Agreement that is qualified by materiality shall be true and correct on the Closing Date as though made on the Closing Date and each of the representations and warranties of Southern Mutual that is not so qualified shall be true and correct in all material respects on the Closing Date as though made on the Closing Date, other than representations and warranties that address matters only as of a certain date, which shall be true and correct in all material respects as of such certain date, and the information concerning Southern Mutual contained in its Annual

Statements for the years ended December 31, 2006, 2007 and 2008 shall be true and correct in all material respects as of the last day of each such year, and Southern Mutual shall deliver to Donegal Mutual on the Closing Date an Officer's Certificate or Certificates to that effect dated as of the Closing Date, and signed on behalf of Southern Mutual;

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

(d) Southern Mutual shall have increased the membership of its Board of Directors to 12 persons and Southern Mutual shall have received the resignations of five directors of Southern Mutual, other than Allen R. Green, on or prior to the Closing Date and Southern Mutual's Board of Directors shall have appointed as directors of Southern Mutual effective as of the Closing Date, with the prior approval of the Commissioner of Insurance, seven persons designated by Donegal Mutual from among the current directors of Donegal Mutual;

(e) Not later than the Closing Date, each of Allen R. Green, W. Daniel Delamater, Martin E. Webb and Kimberly L. McClain shall have entered into an Employment Agreement with Southern Mutual in substantially the form of Appendix D and, except as provided in such Employment Agreements, Southern Mutual shall have no other obligation to any of such persons in respect of his or her employment by Southern Mutual or the termination of such employment;

(f) The policyholders surplus of Southern Mutual, determined in accordance with SAP, shall be not less than \$6.0 million as of the last day of the month immediately preceding the month in which the Closing occurs; and

(g) Southern Mutual shall not have made any material expenditures through the Closing Date, except in accordance with its current Board-approved budget.

6.3 Conditions to Obligations of Southern Mutual. The obligation of Southern Mutual to sell the Surplus Note and to perform its other obligations under this Agreement to be performed on the Closing Date shall, at the option of Southern Mutual, be subject to the satisfaction on or prior to the Closing Date, of the following conditions:

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

(b) There shall have been no material breach by Donegal Mutual in the performance of any of its covenants and agreements in this Agreement, each of the representations and warranties of Donegal Mutual contained in this Agreement that is qualified by materiality shall be true and correct on the Closing Date as though made on the Closing Date and each of the representations and warranties of Donegal Mutual that is not so qualified shall be true and correct in all material respects on the Closing Date as though made on the Closing Date, other than representations and warranties that address matters only as of a certain date and which shall be true and correct in all material respects as of such certain date, and Donegal Mutual shall deliver to Southern Mutual on the Closing Date an Officer's Certificate or Certificates to that effect, dated as of the Closing Date, and signed on behalf of Donegal Mutual;

(c) At Closing, Donegal Mutual shall have tendered to Southern Mutual payment of the purchase price of the Surplus Note as specified in Section 2.2.

ARTICLE VII TERMINATION

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

(a) by mutual consent of Southern Mutual and Donegal Mutual;

(b) subject to Section 7.2, by either Southern Mutual or Donegal Mutual by one day's written notice to Donegal Mutual or Southern Mutual, as the case may be, if the Closing shall not have been consummated on the date determined pursuant to Section 7.2, provided that the right to terminate this Agreement under this Section 7.1(b) shall not be

available to any party whose failure to fulfill any obligation under this Agreement has been the cause of, or resulted in, the failure of the purchase and sale of the Surplus Note to have been consummated on or before such date;

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

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

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

7.2 Final Termination Date. Southern Mutual or Donegal Mutual may terminate this Agreement on one day's notice to Donegal Mutual or Southern Mutual, as the case may be, on the date, if any, on which the Commissioner disapproves the change of control of Southern Mutual described in Donegal Mutual's Form A Statement or on December 31, 2009, whichever shall first occur.

7.3 Effect of Termination. In the event of the termination of this Agreement by either Southern Mutual or Donegal Mutual, as provided in Section 7.1, this Agreement shall thereafter become void, each party shall bear all expenses it incurred, including professional fees, in connection with the transactions contemplated by this Agreement and there shall be

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

ARTICLE VIII

AMENDMENT, WAIVER AND INDEMNIFICATION

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

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

(a) extend the time for the performance of any of the obligations or other acts of the other party hereto,

(b) waive any inaccuracies in the representations and warranties contained in this Agreement or in any document delivered pursuant to this Agreement, and

(c) waive compliance with any of the agreements or conditions contained herein.

Any agreement on the part of a party to any such extension or waiver shall be valid only if set forth in an instrument in writing signed on behalf of such party by its President. The failure of any party hereto to enforce at any time any provision of this Agreement shall not be construed to be a waiver of such provision, nor in any way to affect the validity of this Agreement or any part hereof or the right of such party hereafter to enforce each and every such provision. No waiver of any breach of this Agreement shall be held to constitute a waiver of any other or subsequent breach.

8.3 Survival of Obligations.

(a) The covenants and agreements of Donegal Mutual and Southern Mutual set forth in Section 5.9 of this Agreement shall survive the Closing of the transactions this Agreement contemplates and shall remain in full force and effect until such covenants expire in accordance with the terms thereof.

(b) All certifications, representations and warranties made herein by Southern Mutual and Donegal Mutual and their obligations to be performed pursuant to the terms hereof, shall survive the Closing Date hereunder, notwithstanding any notice of any inaccuracy, breach or failure to perform not waived in writing and notwithstanding the consummation of the transactions contemplated herein with knowledge of such inaccuracy, breach or failure. All representations and warranties contained herein shall terminate upon the earlier of (i) repayment in full of the principal amount of the Surplus Note and all accrued but unpaid interest thereon or (ii) 90 days after Donegal Mutual shall have received the audited financial statements of Southern Mutual for the year ending December 31, 2010; provided that (i) the representations and warranties contained in Section 3.16 shall expire two years after the Closing Date or, with respect to each claim under Section 3.16 arising before or during such two-year period, upon the earlier to occur of (x) such claim's final judicial determination or settlement and satisfaction of any judgment or full payment of any settlement, as the case may be or (y) such time, if any, as the claim shall be barred by the applicable statute of limitations or (z) the payment in full of the Surplus Note and (ii) the representations and warranties contained in Section 3.17 shall expire four years after the Closing Date or with respect to any dispute with the IRS upon the earlier to occur of (x) such dispute's final resolution and the payment of all taxes, interests and penalties arising therefrom and (y) the expiration of the applicable statute of limitations.

8.4 Indemnification.

(a) From and after the Closing Date, Southern Mutual agrees to indemnify and hold harmless Donegal Mutual and its subsidiaries, affiliates, partners, successors and assigns (collectively, the "Indemnified Persons") from and against any and all (x) Liabilities, losses, costs, deficiencies or damages ("Loss") and (y) reasonable attorneys' and accountants' fees and expenses, court costs and all other reasonable out-of-pocket expenses ("Expense") incurred by any Indemnified Person, in each case net of any insurance proceeds received and retained by such Indemnified Person, in connection with or arising from (i) any breach by Southern Mutual of any of its covenants in, or any failure of Southern Mutual to perform any of its obligations under, this Agreement or (ii) any material breach of any warranty or the material inaccuracy of any representation of Southern Mutual contained or referred to in this Agreement or in any Officer's Certificate delivered by or on behalf of Southern Mutual pursuant to this Agreement provided that the liability of Southern Mutual shall be limited (the "Liability Limit") to an aggregate of Two Million Five Hundred Thousand Dollars (\$2,500,000).

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

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

(d) If the remedy sought in any action or suit referred to in paragraph (c) of this Section 8.4 is solely money damages and the sum of (i) the amount claimed in such action or suit, (ii) all amounts previously paid by Southern Mutual pursuant to this Section 8.4 and (iii) all amounts claimed in all pending claims for indemnity under this Section 8.4 does not exceed the aggregate liability of Southern Mutual under this Section 8.4, Southern Mutual shall have 15 business days after receipt of the notice referred to in the last sentence of paragraph (b) of this Section 8.4 to notify the Indemnified Persons that it elects to conduct and control such action or suit. If Southern Mutual does not give the foregoing notice, the Indemnified Persons shall have the right to defend, contest, settle or compromise such action

or suit in the exercise of their exclusive discretion and Southern Mutual shall, upon request from any of the Indemnified Persons, promptly pay to such Indemnified Persons in accordance with the other terms of this Section 8.4 the amount of any Loss resulting from its liability to the third party claimant and all related Expense. If Southern Mutual gives the foregoing notice, Southern Mutual shall have the right to undertake, conduct and control, through counsel of its own choosing and at its sole expense, the conduct and settlement of such action or suit, and the Indemnified Persons shall cooperate with Southern Mutual in connection therewith; provided that (x) Southern Mutual shall not thereby permit to exist any Lien upon any Asset of any Indemnified Person, (y) Southern Mutual shall permit the Indemnified Persons to participate in such conduct or settlement through counsel chosen by the Indemnified Persons, but the fees and expenses of such counsel shall be borne by the Indemnified Persons, except as provided in clause (z) hereof and (z) Southern Mutual shall agree to reimburse promptly to the extent required under this Section 8.4 the Indemnified Persons for the full amount of any Loss resulting from such action or suit and all related Expense incurred by the Indemnified Persons, except fees and expenses of counsel for the Indemnified Persons incurred after the assumption of the conduct and control of such action or suit by Southern Mutual. So long as Southern Mutual is contesting any such action or suit in good faith, the Indemnified Persons shall not pay or settle any such action or suit. Notwithstanding the foregoing, the Indemnified Persons shall have the right to pay or settle any such action or suit, provided that in such event the Indemnified Persons shall waive any right to indemnity therefor by Southern Mutual and no amount in respect thereof shall be claimed as Loss or Expense under this Section 8.4.

ARTICLE IX

MISCELLANEOUS

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

if to Donegal Mutual, to:

Donegal Mutual Insurance Company
1195 River Road, P.O. Box 302
Marietta, Pennsylvania 17547
Attention: Donald H. Nikolaus, President
Facsimile: 717-426-7009

with a copy to:

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

if to Southern Mutual, to:

Southern Mutual Insurance Company
360 Alps Road
Athens, Georgia 30606
Attention: Allen R. Green, President
Facsimile: 706-549-7855

with a copy to:

Constantine & Associates
2900 Paces Ferry Rd., Ste. C-2000
Atlanta, Georgia 30339
Attention: Robert P. Constantine, Jr., Esq.
Facsimile: 404-223-6833

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

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

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

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

Agreement, expressed or implied, is intended to confer upon any other Person any rights or remedies of any nature under or by reason of this Agreement.

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

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

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

9.8 Entire Agreement; Statements as Representations. This Agreement, together with the Surplus Note, the Services Agreement, the Employment Agreements, the Technology License Agreement, the Quota Share Reinsurance Agreement, the Disclosure Schedules, the Confidentiality Agreement and any documents delivered pursuant to Articles II and VI, contain the entire understanding of Southern Mutual and Donegal Mutual with regard to the subject matter of this Agreement. All statements contained in this Agreement or in any schedule, exhibit, certificate, list or other document delivered pursuant to this Agreement shall be deemed representations and warranties as such terms are used in this Agreement.

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

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

DONEGAL MUTUAL INSURANCE COMPANY

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

SOUTHERN MUTUAL INSURANCE COMPANY

By: /s/ Allen R. Green
Allen R. Green, President

QUOTA SHARE REINSURANCE AGREEMENT

THIS QUOTA SHARE REINSURANCE AGREEMENT (this "Agreement") is made this 30th day of October, 2009 but effective as of 11:59 p.m. on October 31, 2009 (the "Effective Date") between SOUTHERN MUTUAL INSURANCE COMPANY, a Georgia mutual insurance company with its principal office in Athens, Georgia ("Southern Mutual"), and DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company with its principal office in Marietta, Pennsylvania ("Donegal Mutual").

WITNESSETH:

WHEREAS, Donegal Mutual has offered to provide reinsurance to Southern Mutual to the extent and on the terms and conditions set forth in this Agreement and nothing stated in this Agreement shall in any manner create any obligations or establish any rights against Donegal Mutual in favor of any person not a party to this Agreement; and

WHEREAS, Southern Mutual has agreed to place such reinsurance with Donegal Mutual to the extent and on the terms and conditions set forth in this Agreement;

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

ARTICLE 1

DEFINITIONS

1.1 Definitions. As used in this Agreement:

"Actual Effective Date Reserves" shall have the meaning set forth in Section 6.1(a)(ii) of this Agreement.

"Allocated Loss Adjustment Expenses" shall mean all court costs, interest upon judgments and mitigation, investigation, adjustment and legal expenses chargeable to or incurred in (i) the mitigation, investigation, negotiation, settlement of or defense against a Loss under a Covered Policy, (ii) loss prevention mitigation or investigation in respect of any Covered Policy as to which Southern Mutual has posted a loss reserve, (iii) the investigation, prevention and workout of a potential Loss under a Covered Policy, (iv) the protection, perfection and exercise of any subrogation or salvage or rights of reimbursement with respect to any Covered Policy or (v) any deficiency resulting from the loss settlement or the workout of a potential Loss under a Covered Policy. Allocated Loss Adjustment Expenses shall

exclude all office expenses and salaries of officers and employees of Southern Mutual. All loss adjustment expenses that are not Allocated Loss Adjustment Expenses shall constitute Unallocated Loss Adjustment Expenses.

"Ceding Commission" shall have the meaning set forth in Section 6.1(b).

"Covered Policies" shall mean an insurance policy first issued by Southern Mutual on or after 12:01 a.m. on January 1, 1976. Donegal Mutual is not assuming any liability from any insurance policy Southern Mutual first issued on or before 12:01 a.m. on January 1, 1976.

"Donegal Mutual" shall have the meaning set forth in the introductory paragraph of this Agreement.

"Effective Date" shall have the meaning set forth in the introductory paragraph of this Agreement.

"Estimated Effective Date Reserves" shall have the meaning set forth in Section 6.1(a)(ii) of this Agreement.

"Extra Contractual Obligations" shall mean all liabilities (i) for compensatory, consequential, exemplary, punitive or similar damages which directly relate to any alleged or actual act, error, omission, fraud or misrepresentation by any Person, any of its affiliates or any of its or its affiliates' officers or employees, whether intentional or otherwise, in connection with the Covered Policies or (ii) from any alleged or actual reckless conduct or bad faith by any Person, any of its affiliates or any of its or its affiliates' officers or employees in connection with such Person's handling of any claim under any of the Covered Policies, including the settlement, defense of or appeal of any claim or in connection with the issuance, offer, sale, delivery, cancellation or administration by any Person or any of its affiliates or any of its or its affiliates' officers or employees under any of the Covered Policies.

"Loss" shall mean (i) amounts incurred by Southern Mutual in settlement or satisfaction of claims under or in respect of the Covered Policies, (ii) any and all Allocated Loss Adjustment Expenses Southern Mutual incurs under or in respect of the Covered Policies, (iii) amounts payable to reinsurers other than Donegal Mutual under or with respect to the Covered Policies and (iv) Extra Contractual Obligations arising after the Effective Date from the acts of Donegal Mutual, in each case net of amounts actually collected by Donegal Mutual or Southern Mutual under Third Party Reinsurance Agreements.

"Occurrence" shall be the definition of said term as set forth in Southern Mutual's Covered Policies, provided, however, in the event "Occurrence" is not defined in any Covered Policy that is reinsured pursuant to this Agreement, then, as to such policy, the term "each Occurrence" shall mean each accident or Occurrence or series of accidents or Occurrences arising out of one event, and shall include aggregate limits of liability for a period not exceeding 12 months when a Covered Policy applies in excess of aggregate limits.

If Southern Mutual and Donegal Mutual cannot specifically determine the date of any Loss, accident, casualty or loss Occurrence, the date of such Loss, accident, casualty or loss Occurrence shall be the inception date of the original Covered Policy reinsured pursuant to this Agreement, provided that such policy period shall be deemed not to exceed 12 calendar months.

“Person” shall mean any individual, corporation, limited liability company, association, joint-stock company, business trust or other similar organization, partnership, joint venture, trust, unincorporated association or government or any agency, instrumentality or political subdivision of a government.

“Quota Share” shall mean 100%.

“Recovery” shall mean any amount actually received by Southern Mutual in respect of any Loss covered by Donegal Mutual under this Agreement, whether by subrogation, salvage, reimbursement or other recovery.

“Recovery Expenses” shall mean any expense, including court costs and legal expenses Southern Mutual incurs for purposes of obtaining a Recovery with respect to Losses, but excluding the expenses and salaries of the officers and employees of Southern Mutual or its affiliates or normal overhead expenses of Southern Mutual and its affiliates and excluding any expense that would constitute an Allocated Loss Adjustment Expense.

“Southern Mutual” shall have the meaning set forth in the introductory paragraph of this Agreement.

“Termination Date” shall have the meaning assigned to it in Section 17.1.

“Third-Party Reinsurance Agreements” shall mean, to the extent such treaties or agreements relate to Covered Policies, (i) all reinsurance treaties and agreements under which Southern Mutual is a ceding party that were in force on the date of this Agreement, and (ii) any such treaty or agreement that is terminated or expired but under which Southern Mutual may continue to receive reinsurance coverage.

“Unallocated Loss Adjustment Expenses” shall have the meaning set forth in the definition of Allocated Loss Adjustment Expenses.

“Ultimate Net Loss” as used in this Agreement means the actual loss Southern Mutual pays or that Southern Mutual becomes liable to pay under the Covered Policies reinsured pursuant to this Agreement, including all loss adjustment expense, 100% of any Extra Contractual Obligations and 100% of any Loss in Excess of Policy Limits as defined in Sections 12.1 and 12.2 of this Agreement. “Ultimate Net Loss” shall include any expenses of litigation, accrued interest where such accrued interest is a part of any judgment, and all other loss expenses of Southern Mutual including legal expenses and costs incurred in

connection with coverage and validity issues and any legal proceedings with respect thereto that are allocable to a Covered Policy.

ARTICLE 2

APPLICATION OF AGREEMENT

2.1 Business Covered. This Agreement applies to all insurance policies Southern Mutual issued that are in effect as of the Effective Date and all policies that Southern Mutual issues after the Effective Date and which Southern Mutual issues during the term of this Agreement until 11:59 p.m. on the Termination Date.

ARTICLE 3

COVER

3.1 Quota Share Reinsurance. Subject to the terms and conditions of this Agreement, Southern Mutual hereby cedes to Donegal Mutual, and Donegal Mutual hereby accepts and reinsures from Southern Mutual, the Quota Share of any Losses, including loss development on all Covered Policies issued prior to the Effective Date, under the Covered Policies. Such Losses and all other liabilities of Southern Mutual with respect to the Covered Policies are sometimes collectively referred to in this Agreement as the "Reinsured Liabilities." Such cession by Southern Mutual and acceptance and reinsurance by Donegal Mutual shall, in the sole discretion of Donegal Mutual, be gross or net of any losses covered by the Third-Party Reinsurance Agreements of Southern Mutual. To the extent Donegal Mutual elects to accept and reinsure such cession net of any losses covered by Third Party Reinsurance Agreements of Southern Mutual, Donegal Mutual hereby guarantees Southern Mutual from and against any uncollectible third-party reinsurance recoverables. Donegal Mutual is not assuming under this Agreement any liabilities of Southern Mutual that do not constitute Reinsured Liabilities and any liabilities of Southern Mutual that are not Reinsured Liabilities shall remain the liabilities of Southern Mutual.

ARTICLE 4

REINSURANCE FOLLOWS ORIGINAL POLICIES

4.1 Follow the Fortunes. Except to the extent specifically otherwise provided in this Agreement or as Southern Mutual and Donegal Mutual may agree in writing, all reinsurance under this Agreement shall be subject in all respects to the same rates, terms, conditions, waivers and interpretations, and to the same modifications, cancellations and alterations as the Covered Policies, the true intent of this Agreement being that Donegal Mutual shall, in every case to which this Agreement applies, follow the fortunes of Southern Mutual; provided, however, that the Agreement shall not be construed to expand the liability

of Donegal Mutual beyond the liabilities Donegal Mutual has specifically assumed pursuant to this Agreement.

4.2 Third-Party Rights. Except as set forth in Sections 7.1 or 13.1, nothing in this Agreement shall in any manner create any obligations or establish any rights against Donegal Mutual in favor of any Person not a party to this Agreement.

ARTICLE 5

CHANGE IN POLICY FORMS

5.1 Policy Forms. Southern Mutual and Donegal Mutual have agreed on the forms of Covered Policies that Southern Mutual will issue and that Donegal Mutual will reinsure pursuant to this Agreement. Southern Mutual shall advise Donegal Mutual of any change in any form of any Covered Policy no less than 90 days prior to the implementation of any such change, and such change shall not be implemented unless Donegal Mutual shall have approved such change in writing within 30 days after receipt of such notice from Southern Mutual, such approval not to be unreasonably withheld by Donegal Mutual.

ARTICLE 6

PREMIUMS AND COMMISSIONS

6.1 Premiums and Commissions. In consideration of the respective obligations of Southern Mutual and Donegal Mutual under this Agreement, Donegal Mutual and Southern Mutual shall make the following respective payments:

(a) On the Effective Date, Southern Mutual shall pay to Donegal Mutual an amount equal to the Effective Date Reserves (as defined below) as follows:

(i) On the Effective Date, Southern Mutual shall pay to Donegal Mutual an amount equal to the Estimated Effective Date Reserves to this Agreement net of the Estimated Effective Date Ceding Commission. The payment this Section 6.1(a)(i) requires shall be made by Southern Mutual's delivery to Donegal Mutual of cash or securities whose value Donegal Mutual shall have approved no earlier than the third business day preceding the Effective Date having a fair market value as of the market close on the business day immediately preceding the Effective Date equal to the amount payable pursuant to this Section 6.1(a)(i).

(ii) Promptly following the Effective Date, Southern Mutual and Donegal Mutual agree to determine the Actual Effective Date Reserves on a definitive basis. Not later than 60 days after the Effective Date, Southern Mutual shall deliver a statement to Donegal Mutual that sets forth Southern Mutual's determination of the Actual Effective Date Reserves. If Donegal Mutual does not provide an objection notice to such statement, such

Southern Mutual statement shall be deemed to have been accepted in the form in which it was delivered to Donegal Mutual and shall be final and binding upon the parties in the absence of fraud or manifest error. If Donegal Mutual shall object to such Southern Mutual statement or if Southern Mutual shall object to any response to such statement by Donegal Mutual, the objecting party shall give the other party written notice of such objection within 30 days of the objecting party's receipt of such statement or response. Such notice of objection shall set forth in reasonable detail the elements and amounts to which the objecting party objects and the basis for such objections. If either party provides an objection notice, the other party, within 15 days after its receipt of the objection notice, shall seek to resolve the objection. In the event Southern Mutual and Donegal Mutual are unable to resolve the objection within 15 days thereafter, the parties shall submit the matter to KPMG LLP ("KPMG") for final resolution of the matter. Within 30 days of the submission of the matter to KPMG, KPMG shall deliver its resolution of the matter to Southern Mutual and Donegal Mutual. KPMG's resolution of the matter shall be binding on Southern Mutual and Donegal Mutual. Southern Mutual and Donegal Mutual shall bear equally the costs of KPMG in determining such resolution.

(iii) To the extent the amount of the Actual Effective Date Reserves as so determined was less than the Estimated Effective Date Reserves, Donegal Mutual shall forthwith remit to Southern Mutual the amount by which the Estimated Effective Date Reserves exceeded the Actual Effective Date Reserves.

(iv) To the extent the amount of the Actual Effective Date Reserves as so determined was greater than the Estimated Effective Date Reserves, Southern Mutual shall forthwith remit to Donegal Mutual the amount by which the Actual Effective Date Reserves exceeded the Estimated Effective Date Reserves.

(b) On the Effective Date, Donegal Mutual shall pay to Southern Mutual a Ceding Commission equal to 36% of the amount of Southern Mutual's unearned premium reserves included in the Estimated Effective Date Reserves as follows:

(i) On the Effective Date, Donegal Mutual shall be deemed to have paid to Southern Mutual an Estimated Ceding Commission equal to 36% of the Estimated Effective Date Reserves (the "Estimated Effective Date Ceding Commission") upon Southern Mutual's netting the amount of the amount of the Estimated Effective Date Ceding Commission against the amount of the Estimated Effective Date Reserves.

(ii) Promptly following the Closing Date, Southern Mutual and Donegal Mutual agree to determine the Actual Effective Date Ceding Commission on a definitive basis according to the determination of the Actual Effective Date Reserves. Not later than 60 days after the Effective Date, Donegal Mutual shall deliver a statement to Southern Mutual that sets forth the amount of the Actual Effective Date Ceding Commission.

(iii) To the extent that the amount of the Actual Effective Date Ceding Commission as so determined exceeds the amount of the Estimated Effective Date Ceding Commission, Donegal Mutual shall forthwith remit to Southern Mutual the amount by which the Actual Effective Date Ceding Commission exceeds the Estimated Effective Date Ceding Commission.

(iv) To the extent that the amount of the Estimated Effective Date Ceding Commission as so determined was greater than the amount of the Actual Effective Date Ceding Commission, Southern Mutual shall forthwith remit to Donegal Mutual the amount by which the Estimated Effective Date Ceding Commission exceeded the Actual Effective Date Ceding Commission.

(c) As additional consideration in connection with the reinsurance this Agreement establishes, Donegal Mutual shall be entitled to the Quota Share of any premium, fee and other amounts actually collected, with the exception of service charges, on or after the Effective Date by Southern Mutual with respect to the Covered Policies and Donegal Mutual shall be responsible for all Losses, including loss development, on Covered Policies after the Effective Date. Southern Mutual shall promptly remit to Donegal Mutual any such amounts that Southern Mutual receives net of any reinsurance reinstatement premiums paid.

(d) If, after the Effective Date, either Southern Mutual or Donegal Mutual discovers an error or omission in the calculation of any amount under this Section 6.1, Southern Mutual and Donegal Mutual shall rectify such error or omission as promptly as practicable after the discovery of the error or omission. Without limiting the foregoing, after the Effective Date, Donegal Mutual will promptly pay to Southern Mutual, upon notice from Southern Mutual, without interest, any amount Southern Mutual paid to Donegal Mutual pursuant to this Agreement, net of Ceding Commissions without interest, with respect to any insurance policy that Southern Mutual or Donegal Mutual determines was not a Covered Policy as of the Effective Date. In addition, in the event that after the Effective Date, Southern Mutual or Donegal Mutual discover that Southern Mutual has made payments to Donegal Mutual pursuant to this Section 6.1 with respect to premiums that have been refunded in whole or in part, Donegal Mutual will promptly upon notice from Southern Mutual return to Southern Mutual, without interest, all of the amount Southern Mutual paid to Donegal Mutual pursuant to this Section 6.1 in respect of such insurance policy to the extent necessary to put Southern Mutual in the same position it would have been in had Southern Mutual been aware of the return of premium prior to the Effective Date net of Ceding Commissions.

ARTICLE 7

LOSSES AND LOSS ADJUSTMENT EXPENSES

7.1 Payment to Southern Mutual for Ultimate Net Losses. Donegal Mutual shall pay to Southern Mutual the Quota Share of sums actually paid by Southern Mutual in

settlement of the Ultimate Net Losses under the Covered Policies, on and after the Effective Date; provided, however, that in the event of the insolvency of Southern Mutual, Donegal Mutual shall pay such amount to the liquidator, receiver or statutory successor of Southern Mutual in accordance with the provisions of Article 13 of this Agreement.

7.2 Expenses to be Borne by Donegal Mutual. Donegal Mutual shall bear its Quota Share of all external loss adjustment expenses Southern Mutual incurs in the investigation, adjustment and litigation of all claims under the Covered Policies.

7.3 Salvage. Donegal Mutual shall receive its Quota Share of all salvage, recoveries and payments received subsequent to a Loss settlement under this Agreement whether received before or after the final adjudication of any claim under the Covered Policies.

7.4 Loss Development. Southern Mutual shall advise Donegal Mutual promptly of all claims and any subsequent loss reserve developments pertaining to the Covered Policies reinsured pursuant to this Agreement.

7.5 Defense of Claims. Southern Mutual shall investigate and, to the extent that may be required by the Covered Policies reinsured under this Agreement, defend any claim affecting the reinsurance provided by this Agreement and pursue such claim to final determination.

7.6 Donegal Mutual Participation. Southern Mutual agrees, upon the request of Donegal Mutual, that when so requested, Southern Mutual will afford Donegal Mutual an opportunity to participate with Southern Mutual, at the expense of Donegal Mutual, in the defense or control of any claim, suit or proceeding involving the reinsurance provided pursuant to this Agreement; and Southern Mutual and Donegal Mutual shall cooperate in all material respects in the defense of such suit, claim or proceeding.

ARTICLE 8

PREMIUM

8.1 Payment of Direct Written Premium. During the term of this Agreement, Donegal Mutual shall assume from Southern Mutual 100% of Southern Mutual's net written premiums applicable to its liability under the Covered Policies for the reinsurance provided pursuant to this Agreement. Southern Mutual shall pay such premiums, net of any premiums for third-party reinsurance.

8.2 Summary Statements. As soon as possible after the end of each month, Southern Mutual shall submit to Donegal Mutual a statement that summarizes the net premiums ceded, return premiums and conversions on Southern's net written business, the actual premiums due, net of commission, and Southern Mutual shall pay to Donegal Mutual any amount due within 15 days of Southern Mutual's delivery of such statement to Donegal

Mutual. Southern Mutual shall furnish quarterly to Donegal Mutual, Southern Mutual's unearned premium reserve on the Covered Policies. Southern Mutual shall compute its unearned premium reserve on the daily pro rata basis.

8.3 Payment of Losses. Donegal Mutual shall pay its proportion of Loss and loss expenses paid by Southern Mutual to Southern Mutual within 15 days after Southern Mutual renders a monthly account summarizing the Losses and loss expenses. Donegal Mutual shall have the right, at its option, to offset the amount of such Loss or loss expense as provided in Article 14.

ARTICLE 9

CEDING COMMISSION

9.1 Payment of Ceding Commission. Donegal Mutual shall pay a ceding commission as provided in Article 6 to Southern Mutual on the net written premiums Southern Mutual cedes to Donegal Mutual under this Agreement. On all return premiums, Southern Mutual shall promptly return to Donegal Mutual the Ceding Commission applicable to such returned premium.

9.2 Statement of Ceding Commission. As soon as possible after the end of each month, Donegal Mutual shall submit to Southern Mutual a statement that sets forth the Ceding Commission fees, and Donegal Mutual shall pay any amount due within fifteen (15) days of Donegal Mutual's receipt of the monthly statements required by Section 8.2.

9.3 Taxes. The Ceding Commission allowance that Donegal Mutual pays to Southern Mutual on the Covered Policies reinsured pursuant to this Agreement includes provision for all premium taxes, licenses and fees with the exception of service charges, assessments and any other expenses whatsoever, except external loss adjustment expenses.

ARTICLE 10

INSPECTION

10.1 Right of Inspection. Southern Mutual shall place at the disposal of Donegal Mutual and Donegal Mutual shall have the right to inspect, through its authorized representatives, at all reasonable times during the term of this Agreement and thereafter, the books, records and papers of Southern Mutual pertaining to the reinsurance provided pursuant to this Agreement and all claims made in connection therewith.

ARTICLE 11

RESERVES AND TAXES

11.1 Maintenance of Reserves. Donegal Mutual shall maintain legal reserves with respect to the unearned premiums and claims it assumes pursuant to this Agreement.

11.2 Premium Taxes. Southern Mutual shall be liable for all taxes on premiums reported to Donegal Mutual under this Agreement and Southern Mutual shall reimburse Donegal Mutual for such taxes where Donegal Mutual is required to pay the same.

ARTICLE 12

EXTRA CONTRACTUAL OBLIGATIONS/EXCESS OF POLICY LIMITS

12.1 Extra Contractual Obligations. The obligations reinsured pursuant to this Agreement shall include Extra Contractual Obligations under the Covered Policies.

12.2 Losses In Excess of Policy Limits. The obligations reinsured pursuant to this Agreement shall include Loss in Excess of Policy Limits with respect to any Covered Policy. "Loss in Excess of Policy Limits" shall mean losses in excess of the policy limit, having been incurred because of, but not limited to, failure by Southern Mutual to settle within the Covered Policy limit or by reason of alleged or actual negligence, fraud or bad faith in rejecting an offer of settlement or in 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.

12.3 Date of Occurrence. An Extra Contractual Obligation and Loss in Excess of Policy Limits shall be deemed to have occurred on the same date as the Loss covered under a Covered Policy, and shall constitute part of the original Loss.

12.4 Meaning of Loss. For the purposes of the Loss in Excess of Policy Limits coverage under this Agreement, the word "Loss" shall mean any amount for which Southern Mutual would have been contractually liable to pay had it not been for the limit of the Covered Policy.

12.5 Loss Adjustment Expense. Loss adjustment expense in respect of Extra Contractual Obligations and Loss in Excess of Policy Limits shall be covered under this Agreement in the same manner as other loss adjustment expense.

12.6 Georgia Law. In no event shall Donegal Mutual provide reinsurance to Southern Mutual to the extent not permitted under the laws of Georgia.

ARTICLE 13
INSOLVENCY CLAUSE

13.1 Insolvency. In the event of the insolvency and the appointment of a conservator, rehabilitator, liquidator or statutory successor of Southern Mutual,

(a) the reinsurance provided by this Agreement and each and every reinsurance agreement heretofore or hereafter entered into between Donegal Mutual and Southern Mutual shall be payable, subject to Section 13.1(b) by Donegal Mutual directly to Southern Mutual or to its conservator, rehabilitator, liquidator, receiver or statutory successor on the basis of the liability of Southern Mutual under the Covered Policies without diminution because of the insolvency of Southern Mutual or because the conservator, rehabilitator, liquidator, receiver, or statutory successor has failed to pay all or any portion of any claims.

(b) Donegal Mutual shall make the payments as set forth above directly to Southern Mutual or to its conservator, rehabilitator, liquidator, receiver or statutory successor. If an insured under a Covered Policy submits a claim to Southern Mutual's conservator, rehabilitator, liquidator, receiver or statutory successor, Donegal Mutual shall have the right, in lieu of making a payment to such conservator, rehabilitator, liquidator, receiver or statutory successor, to make a payment on the claim directly to the insured. Any such payment by Donegal Mutual shall discharge Donegal Mutual from its related payment obligation under such Covered Policy.

ARTICLE 14
OFFSET CLAUSE

14.1 Offset. Except for payments to be made pursuant to Section 6.1, which may only be offset against each other, Donegal Mutual and Southern Mutual shall each have, and may exercise at any time and from time to time, the right to offset any balance or amount, whether on account of premiums, premium adjustments, commissions, claims, Losses, Recoveries or otherwise, due from such party to the other party hereto under this Agreement. The party asserting the right of offset shall have and may exercise such right at any time whether the balance or balances due or to become due to such party from the other are on account of premiums or on account of Losses or otherwise. If Donegal Mutual is required to make a payment directly to an insured under a Covered Policy, no offset shall be allowed between Donegal Mutual and the insured under a Covered Policy, provided, however, that Donegal Mutual shall continue to maintain its offset rights against Southern Mutual pursuant to this Agreement.

ARTICLE 15
ARBITRATION

15.1 Arbitration. Should an irreconcilable difference of opinion arise between Southern Mutual and Donegal Mutual as to the interpretation of this Agreement or the transactions this Agreement contemplates, as a condition precedent to any right of action under this Agreement, such difference shall be submitted to arbitration to the decision of a board of arbitration composed of two arbitrators and an umpire, meeting in Atlanta, Georgia under the rules of the American Arbitration Association.

15.2 Identity of Arbitrators. The members of the board of arbitration shall be active or retired disinterested executive officers of insurance or reinsurance companies. Each party shall appoint one arbitrator and the two arbitrators shall choose an umpire before they enter into arbitration. If either party fails to appoint its arbitrator within four weeks after being requested to do so, the other party shall also appoint the second arbitrator. If the two arbitrators fail to agree upon the appointment of an umpire within four weeks after their nominations, each of them shall name three nominees for umpire, of whom each arbitrator shall decline two nominees and the decision among the two remaining nominees shall be made by the claimant party drawing lots.

15.3 Default Selection. In the event that either party shall fail to choose an arbitrator within four weeks following a request by Donegal Mutual or Southern Mutual for arbitration, the requesting party shall choose two arbitrators who shall choose the umpire.

15.4 Submission of Initial Brief. The claimant shall submit its initial brief within 20 days from appointment of the umpire. The respondent shall submit its brief within 20 days after receipt of the claimant's brief and the claimant may submit a reply brief within 10 days after receipt of the respondent's brief.

15.5 Arbitrator Decision. The board of arbitration shall make its decision with regard to the custom and usage of the insurance and reinsurance business. The board of arbitration shall issue its 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. The board of arbitration shall make its decision within 60 days following the conclusion of the hearings unless the parties consent to an extension. The majority decision of the board of arbitration shall be final and binding upon all parties to the proceeding. Judgment may be entered upon the award of the board of arbitration in any court having jurisdiction thereof.

15.6 Multiple Reinsurers. If more than one reinsurer is involved in the same dispute, all such reinsurers shall constitute and act as one party for purposes of this clause and communications shall be made by Southern Mutual to each of the reinsurers constituting

the one party, provided, however, that nothing therein shall impair the rights of such reinsurers to assert several, rather than joint defenses or claims, nor be construed as changing the liability of the reinsurers under the terms of this Agreement from several to joint.

15.7 Arbitration Expenses. Each party shall bear the expense of its own arbitrator and shall jointly and equally bear with the other party the expense of the umpire. The remaining costs of the arbitration proceedings shall be allocated by the board of arbitration.

ARTICLE 16

GOVERNING LAW

16.1 Governing Law. This Agreement shall be interpreted under and pursuant to the laws of the State of Georgia in all respects.

ARTICLE 17

COMMENCEMENT AND TERMINATION

17.1 Effective Time. This Agreement shall take effect as of 12:01 A.M. on the Effective Date and is entered into for an unlimited term, but either party may terminate the term of this Agreement at any time by giving not less than 12 months notice in writing to the other party of a date of termination of this Agreement (the "Termination Date").

17.2 Participation Until Termination. Donegal Mutual shall participate in business coming within the terms of this Agreement until the date of termination of this Agreement.

17.3 Run-Off. In the event either party terminates this Agreement the reinsurance pursuant to this Agreement shall be provided on a "run-off" basis for all Covered Policies under this Agreement written prior to the Termination Date until all liabilities under the Covered Policies have been satisfied in full.

ARTICLE 18

CURRENCY OF PAYMENT

18.1 Currency of Payment. All payments under this Agreement shall be made in the currency of the United States of America.

ARTICLE 19

ACCESS TO RECORDS

19.1 Access to Records. Donegal Mutual, by its duly appointed representatives, shall have the right at any reasonable time, to examine all papers in the possession of

Southern Mutual that relate to the Covered Policies that Donegal Mutual has reinsured pursuant to this Agreement.

ARTICLE 20

STATISTICS

20.1 Statistics. Southern Mutual shall furnish Donegal Mutual such statistics as may be necessary to comply with statutory requirements and in such form as Donegal Mutual may reasonably request from Southern Mutual.

ARTICLE 21

ERRORS AND OMISSIONS

21.1 Errors and Omissions. Any inadvertent delay, omission or error by either party shall not relieve the other party from any liability that would have attached under this Agreement, provided that such delay, omission or error shall not impose any greater liability on Donegal Mutual than would have attached under this Agreement if such act, delay, omission or error had not occurred, and such act, delay, omission or error is promptly and reasonably rectified upon discovery by the responsible party.

ARTICLE 22

MISCELLANEOUS

22.1 Notices. All reports, remittances, notices, letters, financial statements or any other communications between the parties to this Agreement shall be addressed as follows:

To Donegal Mutual:

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

To Southern Mutual:

Southern Mutual Insurance Company
360 Alps Road
Athens, Georgia 30606
Attention: President
Facsimile: (706) 549-7855

22.2 Assignment. Neither this Agreement nor any rights or obligations under this Agreement may be assigned or otherwise transferred by any party to this Agreement, including by operation of law, without the consent of the other party to this Agreement and the prior approval of the Commissioner of Insurance of the State of Georgia; provided, however, that Donegal Mutual may assign its rights or obligations under this Agreement to any entity that has a current A.M. Best rating equal to or greater than A.

22.3 Severability. If any provision of this Agreement shall be held to be invalid, illegal or unenforceable in any respect, such invalidity, illegality or unenforceability shall not affect any other provision of this Agreement and this Agreement shall be construed as if such invalid, illegal or unenforceable provision had never been part of this Agreement unless the deletion of such provision would result in such a material change as to cause completion or continuation of the transactions contemplated by this Agreement to be unreasonable or materially frustrate the objectives of Southern Mutual and Donegal Mutual as expressed in this Agreement.

22.4 Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be an original, but such counterparts together shall constitute one and the same agreement.

IN WITNESS WHEREOF the parties hereto have caused this Agreement to be executed in duplicate and delivered as of the day and year first above written.

DONEGAL MUTUAL INSURANCE COMPANY

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

SOUTHERN MUTUAL INSURANCE COMPANY

By: /s/ Allen R. Green
Allen R. Green, President

SERVICES AND AFFILIATION AGREEMENT

THIS SERVICES AND AFFILIATION AGREEMENT (this "Agreement") is entered into this 30th day of October, 2009 between SOUTHERN MUTUAL INSURANCE COMPANY, a Georgia mutual fire insurance company ("Southern Mutual") and DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company ("Donegal Mutual") in accordance with the terms of a Surplus Note Purchase Agreement dated as of September 8, 2009 (the "Note Purchase Agreement") with Donegal Mutual. All capitalized terms used herein but not defined herein shall have the respective meanings assigned to them in the Note Purchase Agreement.

WITNESSETH:

WHEREAS, Donegal Mutual purchased on the date hereof a surplus note (the "Surplus Note") of Southern Mutual in the principal amount of Two Million Five Hundred Thousand Dollars (\$2,500,000) pursuant to the Note Purchase Agreement;

WHEREAS, a condition precedent in the Note Purchase Agreement to Donegal Mutual's purchase of the Surplus Note is that Southern Mutual and Donegal Mutual enter into this Agreement to assist Southern Mutual in reducing its expense ratio and to provide advice and assistance to the officers and employees of Southern Mutual in connection with their conduct of the operations of Southern Mutual;

WHEREAS, Donegal Mutual and Southern Mutual are entering into a Quota Share Reinsurance Agreement purchase to which Southern Mutual shall cede to, and Donegal Mutual shall assume from, Southern Mutual up to 100% of the net written premiums of Southern Mutual; and

WHEREAS, Southern Mutual and Donegal Mutual are also entering into a Technology License Agreement whereby Donegal Mutual will license certain of its computer applications and systems to Southern Mutual on the terms and conditions set forth in the Technology License Agreement;

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

1. **Effective Date.** The effective date of this Agreement shall be the date of the Closing under the Note Purchase Agreement. This Agreement shall continue in effect unless and until terminated pursuant to Section 5.

2. Services To Be Rendered.

(a) In order to achieve the objectives of Southern Mutual in entering into this Agreement, Donegal Mutual shall have the authority, subject to the ultimate authority of the Board of Directors of Southern Mutual, to oversee all of Southern Mutual's principal business activities including the following operations:

(i) Underwriting — the development, implementation and administration of policies relating to underwriting and the acceptance of risks, the maintenance of underwriting manuals and guidelines and services relating to the development of rates, the provision of all actuarial services necessary or appropriate for the operation of Southern Mutual's business, the analysis of loss trends and reserve developments and risk concentrations and the arranging for insurance and other reasonable risk management services in the underwriting process to protect Southern Mutual and its properties and other assets against loss, damage and liabilities;

(ii) Claims — the admitting, adjusting, compromising, rejection and settlement of claims under insurance policies issued by Southern Mutual and the collection of reinsurance and recoverables;

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

(iv) Investments — the oversight of the investment of all available funds in the name of and on behalf of Southern Mutual pursuant to its investment policy;

(v) Data Processing Analysis — analysis and consultation regarding the advisability and potential benefits of migrating Southern Mutual's computer systems to Donegal Mutual's computer systems and the adaptation of Southern Mutual's computer system so it can operate Donegal Mutual's WritePro® and WriteBiz® applications;

(vi) Personnel and Professional Services — the appointment, direction, removal and suspension, in the name of and on behalf of Southern Mutual, of employees and agents, including the determination of the appropriate levels thereof, and the ongoing review and analysis of professional services, including the retention of counsel, accountants and other consultants and the payment to them, from the funds of Southern Mutual, of their reasonable fees for services and reasonable expenses incurred in connection with such services;

(vii) Financial Reporting — the analysis and reporting of actual performance to budgeted performance, including analysis of financial results through the

budgeted period and the preparation of all statements and reports necessary or appropriate for Southern Mutual's business, including reports to insurance regulatory authorities.

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

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

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

(b) Donegal Mutual shall use its commercially reasonable efforts to provide the services described above and such other or additional services as Southern Mutual's Board of Directors may from time to time request pursuant to this Agreement in such manner as Southern Mutual's Board of Directors, in its business judgment, exercised in accordance with applicable law, deems necessary or appropriate. Notwithstanding the foregoing, Southern Mutual agrees that Donegal Mutual shall have no obligation to provide services to Southern Mutual of a quality greater than the quality of such services that Donegal Mutual maintains for its own operations. All byproducts from the services provided by Donegal Mutual pursuant to this Agreement shall be the property of Southern Mutual except whereby expressly provided to the contrary in this Agreement or in the Technology License Agreement. Donegal Mutual shall cause the services to be rendered by it to Southern Mutual pursuant to this Agreement to be covered by Donegal Mutual's disaster recovery plans.

(c) Nothing in this Agreement shall constitute or be construed to be or create a partnership or joint venture relationship between Southern Mutual and Donegal Mutual. In connection with the performance of services under this Agreement, neither Southern Mutual nor Donegal Mutual shall make any statement or take any action that is inconsistent with the provisions of this Section 2(c).

3. Payment for Services.

(a) Donegal Mutual agrees to bear the costs of the services Donegal Mutual provides pursuant to this Services Agreement in consideration of the Quota Share Reinsurance Agreement between Donegal Mutual and Southern Mutual. Southern Mutual shall pay from its own funds all of its own operating costs and expenses in accordance with the Ordinary Course of Southern Mutual's business.

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

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

4. Approval by Commissioner. Donegal Mutual and Southern Mutual agree to submit this Agreement and any other required information and filings to the Commissioner of Insurance of the State of Georgia (the "Commissioner") for his review and approval in accordance with the Georgia Insurance Code.

5. Termination; Extension.

(a) This Agreement shall terminate on December 31, 2014, except if extended by Southern Mutual as provided in Section 5(b); and further provided, however, that this Agreement may be terminated at any time prior to such date in any of the following events:

(i) By Donegal Mutual, upon written notice to Southern Mutual, if Southern Mutual shall become insolvent or shall become subject to any voluntary or involuntary conservatorship, rehabilitation, receivership, reorganization, liquidation or bankruptcy case or proceeding or the surplus of Southern Mutual is less than the minimum amount of surplus required by the laws of the State of Georgia for the classes of insurance Southern Mutual is then transacting;

(ii) By Donegal Mutual, upon written notice to Southern Mutual, if the designees of Donegal Mutual shall cease to constitute a majority of the members of the Board of Directors of Southern Mutual;

(iii) By Southern Mutual, upon written notice to Donegal Mutual, if Donegal Mutual shall become insolvent or shall become subject to any voluntary or involuntary conservatorship, receivership, reorganization, liquidation or bankruptcy case or proceeding; or

(iv) By Southern Mutual, upon written notice to Donegal Mutual, subsequent to payment in full of the Surplus Note.

(b) Subject to subsection (a) of this Section 5, Southern Mutual shall have the option to extend the term of this Agreement for one additional year upon delivery of a written notice of extension to Donegal Mutual not later than 90 days prior to the expiration of the then current term. Southern Mutual shall have the right to exercise the extension option for five successive years commencing with an option to extend the scheduled termination date of December 31, 2014 to December 31, 2015 and ending with an option to extend the termination date to December 31, 2019.

(c) Any termination of this Agreement by Donegal Mutual pursuant to Sections 5(a)(i) or 5(a)(ii) of this Agreement shall only become effective (i) 18 months after the date on which written notice of termination is given to Southern Mutual by Donegal Mutual and (ii) subject to the receipt of any necessary insurance regulatory approvals.

6. Confidentiality. Donegal Mutual agrees during the term of this Agreement and subsequent to the termination of this Agreement to hold in confidence all documents, materials and other information that Donegal Mutual shall have obtained about Southern Mutual during the term of this Agreement (the "Confidential Information").

7. Miscellaneous.

(a) All notices or other communications required or permitted under this Agreement shall be in writing and shall be given by confirmed facsimile or registered mail, postage prepaid, addressed as follows:

if to Southern Mutual, to:

Southern Mutual Insurance Company
360 Alps Road
Athens, Georgia 30606
Attention: Allen R. Green, President
Facsimile: 706-549-7855

if to Donegal Mutual, to:

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

Such notice shall be given at such other address or to such other representative as a party to this Agreement may furnish pursuant to this Section 7(a) to the other party to this Agreement.

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

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

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

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

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

SOUTHERN MUTUAL INSURANCE COMPANY

By: /s/ Allen R. Green
Allen R. Green, President

DONEGAL MUTUAL INSURANCE COMPANY

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

TECHNOLOGY LICENSE AGREEMENT

THIS TECHNOLOGY LICENSE AGREEMENT (this "Agreement") is entered into this 30th day of October, 2009 between SOUTHERN MUTUAL INSURANCE COMPANY, a Georgia mutual fire insurance company ("Southern Mutual") and DONEGAL MUTUAL INSURANCE COMPANY, a Pennsylvania mutual fire insurance company ("Donegal Mutual").

WITNESSETH:

WHEREAS, Southern Mutual, in order to obtain additional surplus and assure its future competitive viability, entered into a Surplus Note Purchase Agreement (the "Note Purchase Agreement") dated as of September 8, 2009 with Donegal Mutual;

WHEREAS, Donegal Mutual purchased on the date hereof a surplus note (the "Surplus Note") of Southern Mutual in the principal amount of Two Million Five Hundred Thousand Dollars (\$2,500,000) pursuant to the Note Purchase Agreement;

WHEREAS, a condition precedent to Donegal Mutual's purchase of the Surplus Note is that Southern Mutual and Donegal Mutual enter into this Agreement whereby Donegal Mutual will license certain of its computer applications and systems to Southern Mutual on the terms and conditions set forth in this Agreement; and

WHEREAS, Southern Mutual and Donegal Mutual are also entering into a Services Agreement whereby Donegal Mutual will provide advice and assistance to Southern Mutual in connection with its on-going business operations including the IT System (as defined below);

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

1. Definitions. In this Agreement:

(a) "Applications" means the data processing and computer applications listed on Exhibit A to be licensed by Donegal Mutual for use by Southern Mutual for the following purposes:

- (1) policy underwriting, issuance and administration;
 - (2) claims administration;
 - (3) investment management;
-

(4) payroll administration;

(5) financial and tax accounting, bookkeeping, recordkeeping and reporting, including preparation and keeping of financial journals, ledgers, records, reports and returns relating to all categories of cash inflows and outflows, accounts payable and receivable, income accrued or received, expenses accrued or paid, assets and liabilities; and

(6) general applications to support the foregoing and other aspects of Southern Mutual's business as mutually agreed by Southern Mutual and Donegal Mutual from time to time.

(b) "Data" means the following three types of data:

(1) "Form Data," which means data used to populate Application templates to generate standard forms such as application forms, policy forms, claims forms and financial reporting forms;

(2) "Input Data," which means data to be processed or used by an Application to generate Output Data, such as the information submitted by a policy applicant; and

(3) "Output Data," which means data generated by processing Input Data and/or Form Data on the Applications, such as a completed policy form.

(c) "Hardware" means all computers, servers, processors, routers, communications equipment, storage equipment and other devices, equipment, peripherals and hardware owned by, or leased or licensed to, Donegal Mutual and used or useful in operating the Software.

(d) "IT System" means the Applications, Hardware and Software but excludes the Data.

(e) "Software" means the machine readable object code installed and operated on the Hardware for the products listed on Exhibit A hereto as necessary or useful to support the Applications, as the same may be supplemented, updated, modified or replaced by Donegal Mutual in its reasonable discretion from time to time during the term of this Agreement.

(f) "User Documentation" means all user documentation, manuals and other materials, whether in paper, electronic or other form, provided by Software vendors and/or Donegal Mutual with respect to the Applications.

2. IT Services and License. Upon the terms and subject to the conditions set forth in this Agreement, Donegal Mutual will provide Southern Mutual with access to and use of the Applications on Donegal Mutual's IT System as follows:

(a) Customization of Applications. Donegal Mutual and Southern Mutual agree to establish, within 30 days from the date of this Agreement, a technology transition team consisting of employees of Donegal Mutual and employees of Southern Mutual to facilitate the customization of the Applications for use by Southern Mutual, with commencement of Southern Mutual's use of the Applications expected to occur within six months of the date of this Agreement. Southern Mutual will continue to bear the costs of operating its own existing IT systems as so authorized.

(b) Hosting of IT System. Donegal Mutual will host the IT System on its Hardware and will supply all Software and Applications to Southern Mutual. Southern Mutual will supply all Form Data to populate the Applications, and Donegal Mutual will host the Form Data on its Hardware. Southern Mutual will be responsible for reviewing, updating and maintaining the Form Data during the term of this Agreement.

(c) Administration and Maintenance of IT System. Donegal Mutual will provide, or contract with third parties to provide, all administration and maintenance of Donegal Mutual's IT System, including routine and emergency servicing and maintenance of Hardware and Software, installation and testing of all updates, new versions and patches to the Software as recommended by the vendors and/or agreed by such vendors and Donegal Mutual, routine backup of all Software and Data files hosted on the Hardware, monitoring and implementation of security procedures.

(d) Access to IT System. Southern Mutual and Donegal Mutual will agree to a mutually acceptable process to allow Southern Mutual to designate and change its authorized employee users from time to time. Authorized users may have full or partial access to Data and the IT System, and will have designated rights to process Data on the Applications, as designated by mutual agreement of Southern Mutual and Donegal Mutual. Authorized users who work in designated Southern Mutual facilities will have networked access to the Applications and will also have the ability to access certain Applications over the Internet. Southern Mutual agents who are so designated by Southern Mutual will have comparable access to and use of Donegal Mutual's WritePro System and WriteBiz System and Donegal Mutual's website as is afforded to agents of Donegal Mutual who are so designated by Donegal Mutual.

(e) Facilities Required. All Southern Mutual authorized users will need the communications facilities and services and computer equipment designated in the relevant User Documentation, which will generally include a dedicated high-speed communications link to the IT System (to be arranged by Donegal Mutual at Southern Mutual's cost) for networked access, high-speed Internet access and appropriate computer systems, scanners,

printers and other peripherals, local area networks and other hardware and software. All such facilities will be the responsibility of Southern Mutual and not Donegal Mutual.

(f) User Documentation. Donegal Mutual will provide Southern Mutual with such access to User Documentation in Donegal Mutual's possession or control relating to the Applications as is necessary to permit use of the Applications by Southern Mutual as described in this Agreement.

(g) Training. At the conclusion of the customization of Applications pursuant to Section 2(a), Donegal Mutual will provide initial training for Southern Mutual personnel at the facilities of Southern Mutual as mutually agreed by Southern Mutual and Donegal Mutual and Donegal Mutual shall bear the expenses of providing training to Southern Mutual's personnel.

(h) Form Data and Input Data. Southern Mutual will bear all responsibility for generating and inputting all Form Data and Input Data onto the IT System.

(i) Output Data. Donegal Mutual will use commercially reasonable efforts to ensure that the IT System is capable of generating Output Data using the Form Data and Input Data supplied by Southern Mutual.

(j) Data Transfers, Storage and Retrieval. All electronic files will reside on Donegal Mutual's servers at facilities owned or controlled by Donegal Mutual. In appropriate circumstances, cached or downloaded files may reside at Southern Mutual's facilities on a temporary or permanent basis.

(k) Customer Support. Donegal Mutual will provide Southern Mutual's authorized users with access to and use of its help desk resources for the same purposes and at the same service levels and hours as those made available to employees of Donegal Mutual.

(l) Southern Mutual, for purposes of its customer privacy policy, hereby acknowledges that the Donegal Mutual employees providing the services described in this Agreement constitute a third-party insurance service provider and are authorized to have access to nonpublic personal financial information of the policyholders of Southern Mutual in order to perform their responsibilities under this Agreement.

(m) Donegal Mutual shall use its best efforts to provide the services described above and such other or additional services as Southern Mutual's Board of Directors may from time to time request pursuant to this Agreement in such manner as Southern Mutual's Board of Directors, in its business judgment, exercised in accordance with applicable law, deems necessary or appropriate. Notwithstanding the foregoing, Southern Mutual agrees that Donegal Mutual shall have no obligation to provide services to Southern Mutual of a quality greater than the quality of such services that Donegal Mutual maintains

for its own operations. Donegal Mutual shall include the services to be rendered by it to Southern Mutual pursuant to this Agreement in Donegal Mutual's disaster recovery plans.

3. Financial Arrangements.

(a) In consideration of the Quota Share Reinsurance Agreement between Southern Mutual and Donegal Mutual, Donegal Mutual shall not charge Southern Mutual for the license and support to be provided pursuant to Section 2 of this Agreement.

(b) Southern Mutual will pay from its own funds all of its own operating costs and expenses.

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

(d) Donegal Mutual will be solely responsible for, and will hold harmless and indemnify Southern Mutual, including its successors, officers, directors, employees, agents and affiliates, from and against all losses, claims, damages, liabilities and expenses, including any and all reasonable expenses and attorneys' fees and disbursements incurred in investigating, preparing or defending against any litigation or proceeding, whether commenced or threatened, or any other claim whatsoever, whether or not resulting in any liability, suffered, incurred, made, brought or asserted by any person not a party to this Agreement resulting from any failure of Donegal Mutual to obtain all required legal rights to use the IT System as described in Section 4(b) of this Agreement and to obtain all required licenses necessary for that use, negligence, willful misconduct or fraud of Donegal Mutual or its officers, directors, employees, agents or affiliates or any other person engaged by Donegal Mutual to provide services to Southern Mutual.

4. Intellectual Property Rights.

(a) Donegal Mutual and/or its licensors/vendors will retain ownership of all rights in the IT System, including the Southern Mutual customization work product for the Applications. All access to and use by Southern Mutual of the IT System hereunder will be a

revocable license limited to the scope and purposes enumerated in this Agreement, and Southern Mutual will acquire no other rights in the aforesaid items under this Agreement. Notwithstanding the foregoing, Southern Mutual will retain a non-exclusive license to customization work product for the Applications.

(b) Donegal Mutual has the full legal right to use the IT System and to provide the Applications in accordance with this Agreement and to obtain all required licenses for that use. The provision of the Applications and the use of the IT System and any other material or services provided or licensed to Southern Mutual under this Agreement will not infringe upon the proprietary rights of any Third Party.

(c) Southern Mutual will own all rights in the Form Data and Input Data.

(d) Output Data may comprise derivative works that include elements of Input Data, Form Data and the Applications or Software. Any tangible copies embodying Output Data can be used and retained by Southern Mutual but retention of those rights does not imply ownership of the IT System.

(e) Southern Mutual and Donegal Mutual will coordinate their respective trade secret protection, privacy and information security policies so as to ensure each complies with (i) all applicable laws and regulations, (ii) all applicable contractual commitments to third parties and (iii) best business practices.

(f) Southern Mutual shall not, and shall not permit any of its employees, to disclose, whether orally, in writing or electronically, any confidential information regarding the IT System to any person except authorized employees of Southern Mutual and Donegal Mutual.

(g) Donegal Mutual agrees that its employees performing the services contemplated by this Agreement shall not disclose any nonpublic personal financial information about the policyholders of Southern Mutual in violation of applicable law and the customer privacy policy of Southern Mutual.

5. Risk Allocations.

(a) Southern Mutual will be responsible for accuracy and entry of all Input Data and Form Data. Southern Mutual will ensure that all its access control representatives and authorized users do not use the IT System or any Data held on the IT System (i) for any unlawful purpose, (ii) in any manner that may cause harm to the IT System or any data residing on the IT System, (iii) to provide services for any other business (whether for a fee or not) as a service bureau or otherwise or (iv) for any purpose other than to operate the Applications for Southern Mutual.

(b) Both Southern Mutual and Donegal Mutual will implement commercially reasonable security procedures.

(c) Except as expressly set forth in this Agreement, neither Donegal Mutual nor Southern Mutual makes any representation or warranty to the other, express or implied, including, without limitation, any warranty of description, merchantability or fitness for a particular purpose.

(d) NOTWITHSTANDING ANYTHING IN THIS AGREEMENT OR ELSEWHERE TO THE CONTRARY, IN NO EVENT WILL EITHER PARTY HAVE ANY LIABILITY UNDER THIS AGREEMENT OR OTHERWISE IN RESPECT OF THE SERVICES AND LICENSES THAT ARE THE SUBJECT OF THIS AGREEMENT FOR ANY INDIRECT, CONSEQUENTIAL, INCIDENTAL, COLLATERAL, EXEMPLARY, PUNITIVE, ENHANCED, SPECIAL OR OTHER SIMILAR DAMAGES OF ANY KIND OR NATURE WHATSOEVER, INCLUDING LOST PROFITS TO THE OTHER PARTY FROM FUTURE BUSINESS OPPORTUNITIES, LOSS OF USE OR REVENUE, LOSS OF SAVINGS OR LOSSES BY REASON OF THE COST OF CAPITAL, WHETHER OR NOT THE OTHER PARTY HAS BEEN ADVISED OF, OR OTHERWISE MIGHT OR SHOULD HAVE ANTICIPATED, THE POSSIBILITY OR LIKELIHOOD OF SUCH DAMAGES.

(e) NOTWITHSTANDING ANYTHING IN THIS AGREEMENT TO THE CONTRARY, EXCEPT FOR CLAIMS, DAMAGES, LIABILITIES AND EXPENSES AS DESCRIBED IN SECTION 3(e) OF THIS AGREEMENT, THE AGGREGATE LIABILITY OF EITHER PARTY TO THE OTHER PARTY UNDER THIS AGREEMENT FOR ANY REASON AND UPON ALL CLAIMS OR CAUSES OF ACTION WILL BE LIMITED TO A MAXIMUM OF THE AGGREGATE AMOUNT OF THE FEES AND EXPENSES PAID OR PAYABLE BY SOUTHERN MUTUAL TO DONEGAL MUTUAL UNDER THIS AGREEMENT. THE LIMITATION OF LIABILITY SET FORTH IN THIS SECTION 5(e) APPLIES TO ALL CAUSES OF ACTION OR CLAIMS IN THE AGGREGATE, INCLUDING BREACH OF CONTRACT, BREACH OF WARRANTY, NEGLIGENCE, STRICT LIABILITY, MISREPRESENTATION OR ANY OTHER LEGAL OR EQUITABLE GROUNDS, EXCEPT FOR CLAIMS, DAMAGES, LIABILITIES AND EXPENSES AS DESCRIBED IN SECTION 3(e) OF THIS AGREEMENT.

(f) Donegal Mutual will not be held responsible or incur any liability for any delay or failure in performance of any part of this Agreement to the extent that such delay or failure results from causes beyond its control, including fire, flood, explosion, war, labor dispute, embargo, government requirement, civil or military authority, natural disasters or other similar types of situations. If such a situation occurs, Donegal Mutual will give prompt notice to Southern Mutual and Donegal Mutual will use commercially reasonable efforts to resume performance, to the extent possible, as soon as practical after the cessation of the situation. This Section 5(f) will not relieve Southern Mutual of its obligation

to pay all fees and expenses that are due Donegal Mutual but may be the basis for a delay in payment.

6. Miscellaneous Provisions.

(a) This Agreement is effective on the Closing Date (as defined in the Note Purchase Agreement) and will terminate on December 31, 2014, except if extended by Southern Mutual as provided in Section 6(b); provided, however that this Agreement may be terminated at any time prior to such date in any of the following events:

(i) By Donegal Mutual, upon written notice to Southern Mutual, if Southern Mutual becomes insolvent or becomes subject to any voluntary or involuntary conservatorship, rehabilitation, receivership, reorganization, liquidation or bankruptcy case or proceeding or the surplus of Southern Mutual is less than the minimum amount of surplus required by the laws of the State of Georgia for the classes of insurance Southern Mutual is then transacting;

(ii) By Donegal Mutual, upon written notice to Southern Mutual, if the designees of Donegal Mutual cease to constitute a majority of the members of the Board of Directors of Southern Mutual;

(iii) By Southern Mutual, upon written notice to Donegal Mutual, if Donegal Mutual becomes insolvent or becomes subject to any voluntary or involuntary conservatorship, receivership, reorganization, liquidation or bankruptcy case or proceeding;

(iv) By Southern Mutual, upon written notice to Donegal Mutual, subsequent to payment in full of the Surplus Note; or

(v) By Donegal Mutual or Southern Mutual, upon written notice to the other, upon the termination of the Services Agreement in accordance with its terms. Termination of this Agreement pursuant to this section 6(a)(v) shall be effective on the same date as the termination of the Services and Affiliation Agreement becomes effective.

(b) Subject to Section 6(a), Southern Mutual shall have the option to extend the term of this Agreement for one additional year upon delivery of a written notice of extension to Donegal Mutual not later than 90 days prior to the expiration of the then current term. Southern Mutual will have the right to exercise the extension option for five successive years commencing with an option to extend the scheduled termination date of December 31, 2014 to December 31, 2015 and ending with an option to extend the termination date to December 31, 2019.

(c) Any termination of this Agreement by Donegal Mutual pursuant to Sections 6(a)(i), 6(a)(ii) or 6(a)(v) of this Agreement shall only become effective after (i) 18 months after written notice of such termination is given to Southern Mutual by Donegal

Mutual and (ii) subject to the receipt of any necessary insurance regulatory approvals and filings.

(d) Donegal Mutual agrees that upon termination or expiration of this Agreement for any reason, Donegal Mutual will exercise commercially reasonable efforts and cooperation to effect an orderly and efficient transition to a successor provider of Applications.

(e) Southern Mutual will be responsible for any federal, state or local income, excise, ad valorem, sales or use taxes imposed with respect to the services and license made available or provided under this Agreement other than any tax that may be imposed on the income of Donegal Mutual.

(f) Donegal Mutual will arrange for all Data residing on its Hardware to be covered by any insurance coverage it maintains for other data residing on its Hardware, and the incremental cost of such coverage will be for the account of Southern Mutual.

(g) All notices or other communications required or permitted under this Agreement shall be given in writing and shall be given by confirmed facsimile or registered mail, postage prepaid, addressed as follows:

if to Southern Mutual, to:

Southern Mutual Insurance Company
360 Alps Road
Athens, Georgia 30606
Attention: Allen R. Green, President
Facsimile: 706-549-7855

if to Donegal Mutual, to:

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

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

(h) No assignment, transfer or delegation, whether by merger or other operation of law or otherwise, of any rights or obligations under this Agreement will be

made by a party to this Agreement without the prior written consent of the other party to this Agreement and, if required by applicable law, the Commissioner of Insurance of the State of Georgia and any other insurance regulatory authority having jurisdiction over this Agreement. This Agreement will be binding upon the parties hereto and their respective permitted successors and assigns.

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

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

(k) This Agreement will be governed by and construed in accordance with the laws of the State of Georgia.

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

SOUTHERN MUTUAL INSURANCE COMPANY

By: /s/ Allen R. Green
Allen R. Green, President

DONEGAL MUTUAL INSURANCE COMPANY

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

Network Software:

ImageRight	Electronic Document Imaging
Allenbrook	Commercial Underwriting and Policy Issuance
www.donegalgroup.com	Internet Web Site Functionality
WritePro	Personal Lines Automated Underwriting and Policy Issuance System (Proprietary)
WriteBiz	Commercial Lines Automated Underwriting and Policy Issuance System (Proprietary)
SCSI (JBIAIS)	Report Ordering Software Utilized in WritePro Application
Cold Fusion Web Software	Web Site Development Tool
Oracle	Database Management
Cognos	Database Report Writing Tool
Polk	Vehicle Identification Number Database
Map Info	Mapping Software used in WritePro
Mapquest	Location Software used for the Website Agency Locator
Transall	Print Software used within Allenbrook
Group1, PC Finalist	Address Verification Software
CITRIX	Remote Access
CA, Allenbrook Interface	Interfaces Allenbrook to the Mainframe Applications
Quest Reporter	Report Writing Tool used in WritePro
Blue Cod Products	Add-on Products to the Allenbrook Application
Phoenix Direct	Agency Front-End to Allenbrook
ACORD AL3	Industry-Standard Interface used in Data Transmission to and from Agency Systems
ISO, PPC Location, WP	Software used to Code Property Protection Classes in WritePro
SQL for WritePro	Programming Language used in WritePro
Guidewire Claims Center	Claims Management
ADP	Payroll
Great Plains Dynamics	General Ledger and Accounts Payable
Sungard EPS	Investment Accounting

Mainframe Software:

CA QA Hyperstation
Docucorp
CSC V7
BCMS
IBM VM
IBM System Software
CA System Software
MacKinney
Finalist
CompuWare System Software
Polk
Solimar

Mainframe Quality Assurance Management
Policy Document Maintenance
Policy Management and Billing System
Account Billing System
Mainframe Operating System Software
Mainframe Operating System Software
Mainframe Operating System Software
Mainframe Operating System Software
Address Verification Software
Mainframe Operating System Software
Vehicle Identification Number Database
Mainframe Interface to ImageRight

AMENDED AND RESTATED PROPORTIONAL REINSURANCE AGREEMENT

THIS AMENDED AND RESTATED PROPORTIONAL REINSURANCE AGREEMENT (this "Agreement") is made and entered into as of March 1, 2010 between DONEGAL MUTUAL INSURANCE COMPANY, a mutual fire insurance company organized and existing under the laws of the Commonwealth of Pennsylvania ("Donegal Mutual"), and ATLANTIC STATES INSURANCE COMPANY, a stock casualty insurance company organized and existing under the laws of the Commonwealth of Pennsylvania ("Atlantic States").

WITNESSETH:

WHEREAS, Donegal Mutual determined in 1986 to implement a downstream insurance holding company structure in order to develop additional sources of capital and surplus so that Donegal Mutual could remain competitive, support its capacity to expand its business and assure its long-term viability;

WHEREAS, Donegal Mutual established a downstream insurance holding company structure in 1986 by the formation of Donegal Group Inc., a Delaware business corporation ("DGI"), as a wholly owned subsidiary of Donegal Mutual, and by the formation of Atlantic States as a wholly owned subsidiary of DGI;

WHEREAS, a proportional reinsurance agreement (the "Original Agreement") between Donegal Mutual and Atlantic States became effective as of 12:01 a.m. on October 1, 1986 (the "Original Effective Time") and Donegal Mutual and Atlantic States each commenced the transfer of substantially all of their respective premiums, losses and expenses to an underwriting pool (the "Underwriting Pool");

WHEREAS, Donegal Mutual and Atlantic States have amended the Original Agreement on October 1, 1988, July 16, 1992, December 21, 1995, April 20, 2000, February 11, 2008 and October 16, 2008 (collectively, the "Amendments") to increase the amount and percentage of business allocated to Atlantic States from the Underwriting Pool from 35% in 1986 to 80% on and after March 1, 2008;

WHEREAS, Donegal Mutual and Atlantic States have agreed, subject to the receipt of the approvals noted below, by this Agreement to amend the Original Agreement as amended by the Amendments and to restate in this Agreement the Original Agreement as amended by the Amendments and this Agreement;

WHEREAS, since 1986 Donegal Mutual and DGI have maintained a coordinating committee (the "Coordinating Committee") that consists of two directors of Donegal Mutual

who are not also directors of DGI and two directors of DGI who are not also directors of Donegal Mutual to review and evaluate any new agreement or relationship or any change in an existing agreement or relationship between Donegal Mutual and DGI or any DGI subsidiary, including the Original Agreement and the Amendments;

WHEREAS, at a meeting held on January 27, 2010, the Coordinating Committee unanimously determined that this Agreement is fair and equitable to Donegal Mutual and its policyholders and that this Agreement is fair and equitable to DGI and its stockholders;

WHEREAS, the Board of Directors of Donegal Mutual believes this Agreement is in the best interests of Donegal Mutual and its policyholders and, at a meeting held on February 18, 2010, approved the execution and delivery of this Agreement by Donegal Mutual;

WHEREAS, the Board of Directors of Atlantic States believes this Agreement is in the best interests of Atlantic States and its stockholder and, at a meeting held on February 18, 2010, approved the execution and delivery of this Agreement by Atlantic States; and

WHEREAS, Donegal Mutual and Atlantic States have agreed to include in the Underwriting Pool such net premiums, losses and expenses that the Coordinating Committee has approved in the past and may approve in the future;

NOW, THEREFORE, Donegal Mutual and Atlantic States, in consideration of their mutual covenants and agreements contained in the Original Agreement, the Amendments and this Agreement, and intending to be legally bound hereby, covenant and agree as follows:

1. Definitions. As used in this Agreement, the following words or phrases shall have the following respective meanings:

"Affiliate" shall mean a Person that directly, or indirectly through one or more intermediaries, controls, is controlled by or is under common control with another Person or beneficially owns or has the power to vote or direct the vote of 10% or more of any class of voting stock or of any form of voting equity interest of such other Person in the case of a Person that is not a corporation. For purposes of this definition, "control", including the terms "controlling" and "controlled", means the power to direct or cause the direction of the management and policies of a Person, directly or indirectly, whether through the ownership of securities or partnership or other ownership interests, by contract or otherwise. The term "Affiliate" shall include any insurance company as to which either Donegal Mutual or DGI has the right to elect a majority of the members of such insurance company's board of directors.

"Agreement" shall have the meaning ascribed to it in the preamble.

“Annual Statements” shall mean the annual statements of condition and affairs Donegal Mutual and Atlantic States file pursuant to the Pennsylvania Insurance Company Law.

“Ceding Company” shall mean Donegal Mutual and Atlantic States.

“Commissioner of Insurance” shall mean the Commissioner of Insurance of the Commonwealth of Pennsylvania.

“Effective Time” shall mean 12:01 a.m., Eastern Standard Time, on March 1, 2010.

“Insurance Liabilities” shall mean a liability, obligation, claim or cause of action of any kind or nature whatsoever, whether absolute, accrued, contingent or other and whether known or unknown, including, without limitation, outstanding case and incurred-but-not-reported loss and loss adjustment reserves, unearned premiums and any other liability, obligation, claim or cause of action arising as a result to an insurance policy issued by Donegal Mutual or Atlantic States. Insurance Liabilities shall also include the Insurance Liabilities assumed from an Affiliate to the extent the Coordinating Committee shall have approved such inclusion in advance.

“Net Expenses” shall mean loss expenses incurred and other underwriting expenses incurred, including expense items that reflect underwriting, including dividends to policyholders but excluding investment income expenses and federal income taxes, all as shown on the Annual Statements for the particular year. All investment income and expenses allocable to the investment operations of Donegal Mutual and Atlantic States under the statutory accounting principles prescribed or permitted by the Insurance Department of the Commonwealth of Pennsylvania shall not be included and shall not be subject to this Agreement.

“Net Liability” shall mean (i) the direct liability of Donegal Mutual or Atlantic States as evidenced by all outstanding policies of insurance issued by Donegal Mutual or Atlantic States less reinsurance purchased with respect thereto from other insurers not a party to this Agreement and (ii) the assumed liability of Donegal Mutual or Atlantic States related to the reinsurance of the Insurance Liabilities of an Affiliate to the extent the Coordinating Committee shall have approved such inclusion in advance.

“Net Premiums and Losses” shall mean the net written premiums and net losses paid of Donegal Mutual or Atlantic States after Atlantic States or Donegal Mutual gives effect to reinsurance transactions with other insurers or reinsurers who are not a party to this Agreement, including the net written premiums and net losses paid Donegal Mutual or Atlantic States may from time to time assume from an Affiliate but only to the extent the Coordinating Committee shall have approved such inclusion in advance.

"Person" shall mean an individual, corporation, partnership, association, joint stock company, governmental entity, business trust, unincorporated organization or other legal entity.

2. General Provisions.

(a) This Agreement shall become effective as of 12:01 a.m., Eastern Standard Time, on March 1, 2010 (the "Effective Time").

(b) In the event that a Ceding Company becomes insolvent or is otherwise subject to liquidation or receivership proceedings, the remaining accepting companies shall adjust their respective assumed portions of the combined Net Liability of the Ceding Companies, each on a pro rata basis, so as to absorb or assume collectively in full the Net Liability of the Ceding Companies, including the portion that would otherwise be the responsibility of the insolvent or otherwise impaired Ceding Company.

3. Ceding and Accepting the Book of Business Then in Force.

(a) From and after the Effective Time, Atlantic States shall, as provided in the Original Agreement, the Amendments and in this Agreement, continue to cede all of the Insurance Liabilities of Atlantic States to the Underwriting Pool.

(b) From and after the Effective Time, Donegal Mutual shall, as provided in the Original Agreement, the Amendments and in this Agreement, continue to cede all of the Insurance Liabilities of Donegal Mutual to the Underwriting Pool.

(c) From and after the Effective Time, Donegal Mutual shall continue to accept and assume its proportionate share as set forth on Exhibit I to this Agreement of the Insurance Liabilities of the Underwriting Pool outstanding on or after the Effective Time. Donegal Mutual shall continue to be solely responsible for Insurance Liabilities related to loss occurrences that took place prior to the Original Effective Time.

(d) From and after the Effective Time, Atlantic States shall continue to accept and assume its proportionate share as set forth on Exhibit I to this Agreement the Insurance Liabilities of the Underwriting Pool outstanding on or after the Effective Time. Atlantic States shall not be liable for Insurance Liabilities related to loss occurrences that took place prior to the Original Effective Time.

4. Accounting. Donegal Mutual and Atlantic States agree as follows:

(a) To the extent that transfers of non-cash assets may be required to effectuate the settlements this Agreement requires, any such transfers shall be made at fair market values as of the date either Donegal Mutual or Atlantic States makes such transfers.

(b) Atlantic States and Donegal Mutual agree to render to the other party a monthly accounting within 30 days after the close of each month and the other party shall have the opportunity for examination and audit, and the balance due shall be paid not later than 90 days after the close of the applicable month.

5. Termination.

(a) Donegal Mutual and Atlantic States agree that this Agreement shall continue in effect for an indeterminate period. This Agreement shall be subject to termination only upon 90 days advance notice from one party to the other party. Any such termination shall only be effective at the next succeeding December 31, and Donegal Mutual and Atlantic States shall provide coverage on a "run-off" basis for policies issued prior to the effective date of the termination until all liabilities under such policies have been satisfied in full.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed by their respective officers thereunto duly authorized on this 1st day March, 2010.

[SEAL]

DONEGAL MUTUAL INSURANCE COMPANY

Attest:

/s/ Sheri O. Smith

Sheri O. Smith, Secretary

By: /s/ Donald H. Nikolaus

Donald H. Nikolaus, President

[SEAL]

ATLANTIC STATES INSURANCE COMPANY

Attest:

/s/ Cyril J. Greenya

Cyril J. Greenya, Senior Vice President

By: /s/ Jeffrey D. Miller

Jeffrey D. Miller, Senior Vice President

EXHIBIT I

Name of Party	Corporation Pool Participation
Donegal Mutual Insurance Company	20%
Atlantic States Insurance Company	80%



SELECTED CONSOLIDATED FINANCIAL DATA

Year Ended December 31,	2009	2008	2007	2006	2005
INCOME STATEMENT DATA					
Premiums earned	\$355,025,477	\$346,575,266	\$310,071,534	\$301,478,162	\$294,498,023
Investment income, net	20,630,583	22,755,784	22,785,252	21,320,081	18,471,963
Realized investment gains (losses)	4,479,558	(2,970,716)	2,051,050	1,829,539	1,802,809
Total revenues	386,733,407	372,424,227	340,618,294	329,967,034	319,847,194
Income before income taxes	20,676,689	32,092,044	52,848,938	56,622,263	52,345,495
Income taxes	1,846,611	6,550,066	14,569,033	16,407,541	15,395,998
Net income	18,830,078	25,541,978	38,279,905	40,214,722	36,949,497
Basic earnings per share — Class A	.76	1.03	1.55	1.65	1.57
Diluted earnings per share — Class A	.76	1.02	1.53	1.60	1.51
Cash dividends per share — Class A	.45	.42	.36	.33	.30
Basic earnings per share — Class B	.68	.92	1.39	1.48	1.41
Diluted earnings per share — Class B	.68	.92	1.39	1.48	1.41
Cash dividends per share — Class B	.40	.37	.31	.28	.26
BALANCE SHEET DATA AT YEAR END					
Total investments	\$666,835,186	\$632,135,526	\$605,869,587	\$591,337,674	\$547,746,114
Total assets	935,601,927	880,109,036	834,095,576	831,697,811	781,421,588
Debt obligations	15,465,000	15,465,000	30,929,000	30,929,000	30,929,000
Stockholders' equity	385,505,699	363,583,865	352,690,191	320,802,262	277,896,186
Book value per share	15.12	14.29	13.92	12.70	11.30

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

General

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

At December 31, 2009, Donegal Mutual owned approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

In March 2007, our board of directors authorized a share repurchase program, pursuant to which we purchased 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission (SEC) Rule 10b-18 and in privately negotiated transactions. We purchased 19,231 and 214,343 shares of our Class A common stock under this program during 2009 and 2008, respectively. As of December 31, 2009, we had no remaining authorization to purchase shares under this program.

In December 2006, Donegal Mutual consummated an affiliation with Sheboygan. As part of the affiliation, Donegal Mutual made a \$3.5 million contribution note investment in Sheboygan. During 2008, Sheboygan's board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired Sheboygan as of December 1, 2008 for approximately \$12.0 million in cash, including payment of the contribution note and accrued interest to Donegal Mutual.

In February 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We purchased 7,669 shares of our Class A common stock under this program during 2009. As of December 31, 2009, we had the authority to purchase 292,331 shares under this program.

In October 2009, Donegal Mutual consummated an affiliation with Southern Mutual Insurance Company ("Southern Mutual"), pursuant to which Donegal Mutual purchased a surplus note of Southern Mutual in the principal amount of \$2.5 million, Donegal Mutual designees became a majority of the members of Southern Mutual's board of directors and Donegal Mutual agreed to provide quota share reinsurance to Southern Mutual for 100% of its business. Effective October 31, 2009, Donegal Mutual began to include business assumed from Southern Mutual in its pooling agreement with Atlantic States. Southern Mutual writes primarily personal lines of insurance in Georgia and South Carolina and had direct premiums written of approximately \$13.3 million for the year ended December 31, 2009.

Pooling Agreement and Other Transactions with Affiliates

In the mid-1980's, Donegal Mutual recognized the need to develop additional sources of capital and surplus to remain competitive and to have the capacity to expand its business and assure its long-term viability. Donegal Mutual determined to implement a downstream holding company structure as a strategic response. Thus, in 1986, Donegal Mutual formed us as a downstream holding company, then wholly owned by Donegal Mutual. We in turn formed Atlantic States as our wholly owned subsidiary. Donegal Mutual and Atlantic States then entered into a proportional reinsurance agreement, or pooling agreement, in 1986. Under this pooling agreement, Donegal Mutual and Atlantic States pool substantially all of their respective premiums, losses and loss expenses. Donegal Mutual then cedes 80% of the pooled business to Atlantic States.

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

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

In addition, as the Donegal Insurance Group, Donegal Mutual and our insurance subsidiaries share a combined business plan to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual offer are generally complementary, thereby allowing the Donegal Insurance Group to offer a broader range of products to a given market and to expand the Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier versus standard tier products, but we and Donegal Mutual do not allocate all of the standard risk gradients to one company. Therefore, the underwriting

profitability of the business written directly by the individual companies will vary. However, since the underwriting pool homogenizes the risk characteristics of all business written directly by Donegal Mutual and Atlantic States, Donegal Mutual and Atlantic States share the underwriting results in proportion to their respective participation in the pool. We realize 80% of the underwriting results of the pool because of the 80% participation of Atlantic States in the underwriting pool. The business Atlantic States derives from the pool represents the predominant percentage of our total revenues. See Note 3 — Transactions with Affiliates for more information regarding the pooling agreement.

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

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

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

The intent of the quota-share reinsurance agreement with Le Mars is to transfer to Le Mars 100% of the premiums and losses related to certain products Donegal Mutual offers in certain Midwest states, which provide the availability of additional complementary products to Le Mars' commercial accounts.

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

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

Donegal Mutual provides facilities, personnel and other services to us and our insurance subsidiaries. Donegal Mutual allocates certain related expenses to Atlantic States in relation to the relative participation of Donegal Mutual and Atlantic States in the pooling agreement. Our insurance subsidiaries other than Atlantic States reimburse Donegal Mutual for their personnel costs and bear their proportionate share of information services costs based on their percentage of total written premiums of the Donegal Insurance Group.

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

There were no significant changes to the pooling agreement or other reinsurance agreements with Donegal Mutual during 2009 and 2008 except as noted above.

Critical Accounting Policies and Estimates

We combine our financial statements with those of our insurance subsidiaries and present them on a consolidated basis in accordance with United States generally accepted accounting principles (GAAP).

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

Liability for Losses and Loss Expenses

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

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

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

interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at December 31, 2009. For every 1% change in our insurance subsidiaries' estimate for loss and loss expense reserves, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately \$1.8 million.

The establishment of appropriate liabilities is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed our insurance subsidiaries' loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, since the historical conditions and events that serve as a basis for our insurance subsidiaries' estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods their estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date. Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$9.8 million, \$2.7 million and (\$10.0) million in 2009, 2008 and 2007, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and there have been no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in those years. The majority of the 2009 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2009 development represented 6.0% of our December 31, 2008 carried reserves and was driven primarily by higher-than-expected severity in the private passenger automobile liability, homeowners and workers' compensation lines of business in accident year 2008.

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

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

Our insurance subsidiaries' liability for losses and loss expenses by major line of business as of December 31, 2009 and 2008 consisted of the following:

(in thousands)	2009	2008
Commercial lines:		
Automobile	\$ 21,465	\$ 19,758
Workers' compensation	38,092	36,667
Commercial multi-peril	30,640	27,808
Other	1,886	1,893
Total commercial lines	92,083	86,126
Personal lines:		
Automobile	70,019	60,939
Homeowners	16,312	11,796
Other	1,848	2,445
Total personal lines	88,179	75,180
Total commercial and personal lines	180,262	161,306
Plus reinsurance recoverable	83,337	78,503
Total liability for losses and loss expenses	\$263,599	\$239,809

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

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2009	Percentage Change in Equity as of December 31, 2009 ⁽¹⁾	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2008	Percentage Change in Equity as of December 31, 2008 ⁽¹⁾
	(dollars in thousands)			
-10.0%	\$162,236	3.0%	\$145,175	2.9%
-7.5	166,742	2.3	149,208	2.2

-5.0	171,249	1.5	153,241	1.4
-2.5	175,755	0.8	157,273	0.7
Base	180,262	—	161,306	—
2.5	184,769	-0.8	165,339	-0.7
5.0	189,275	-1.5	169,371	-1.4
7.5	193,782	-2.3	173,404	-2.2
10.0	198,288	-3.0	177,437	-2.9

(1) Net of income tax effect.

Our insurance subsidiaries base their reserves for unpaid losses and loss expenses on current trends in loss and loss expense development and reflect their best estimates for future amounts needed to pay losses and loss expenses with respect to incurred events currently known to them plus incurred but not reported ("IBNR") claims. Our insurance subsidiaries develop their reserve estimates based on an assessment of known facts and circumstances, review of historical loss settlement patterns, estimates of trends in claims severity, frequency, legal and regulatory changes and other assumptions. Actuarial loss reserving techniques and assumptions, which rely on historical information as adjusted to reflect current conditions, are consistently applied, including consideration of recent case reserve activity. For the year ended December 31, 2009, our insurance subsidiaries used the most-likely number as determined by our actuaries. Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2009, we developed a range from a low of \$165.6 million to a high of \$196.2 million and with a most-likely number of \$180.3 million. The range of estimates for commercial lines in 2009 was \$84.6 million to \$100.2 million (we selected the actuaries' most-likely number of \$92.1 million) and for personal lines in 2009 was \$81.0 million to \$96.0 million (we selected the actuaries' most-likely number of \$88.2 million). Based upon information provided by our actuaries during the development of our insurance subsidiaries' net reserves for losses and loss expenses for the year ended December 31, 2008, we developed a range from a low of \$147.9 million to a high of \$176.0 million and with a most-likely number of \$161.3 million. The range of estimates for commercial lines in 2008 was \$79.0 million to \$94.0 million (we selected the actuaries' most-likely number of \$86.1 million) and for personal lines in 2008 was \$68.9 million to \$82.1 million (we selected the actuaries' most-likely number of \$75.2 million).

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. For personal lines products, our insurance subsidiaries insure standard and preferred risks in private passenger automobile and homeowners lines. For commercial lines products, the commercial risks that our insurance subsidiaries primarily insure are mercantile risks, business offices, wholesalers, service providers, contractors and artisan risks, limiting industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or professional liability risks. Through the consistent application of this disciplined underwriting philosophy, our insurance subsidiaries have avoided many of the "long-tail" issues other insurance companies have faced. We consider workers' compensation to be a "long-tail" line of business, in that workers' compensation claims tend to be settled over a longer timeframe than those in our other lines of business. The following table presents 2009 and 2008 claim count and payment amount information for workers' compensation. Workers' compensation losses primarily consist of indemnity and medical costs for injured workers. Substantially all of the claims are relatively small individual claims of a similar type.

	For the Year Ended December 31,	
	2009	2008
	(dollars in thousands)	
Number of claims pending, beginning of period	1,401	1,452
Number of claims reported	2,449	2,976
Number of claims settled or dismissed	2,554	3,027
Number of claims pending, end of period	1,296	1,401
Losses paid	\$ 17,131	\$ 17,068
Loss expenses paid	3,944	3,377

Investments

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we write down the investment to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of original cost and has been in such an unrealized loss position for more than six months. We held five equity securities that were in an unrealized loss position at December 31, 2009. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we considered these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 73 debt securities that were in an unrealized loss position at December 31, 2009. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary. We included losses of \$0, \$1.2 million and \$469,000 in net realized investment gains (losses) in 2009, 2008 and 2007, respectively, for certain equity investments trading below cost on an other-than-temporary basis.

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2009 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$26,703,601	\$ 585,364	\$ —	\$ —
Obligations of states and political subdivisions	17,971,018	256,527	29,582,488	786,970
Corporate securities	1,284,405	23,525	666,941	61,366
Residential mortgage-backed securities	23,514,855	328,969	477,421	543
Equity securities	2,139,457	227,798	—	—
Totals	\$71,613,336	\$1,422,183	\$30,726,850	\$848,879

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

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	117,360,120	6,880,692	65,626,857	3,331,443
Corporate securities	16,780,992	448,760	2,536,165	733,109
Residential mortgage-backed securities	2,925,368	24,376	2,928,685	22,526
Equity securities	484,000	59,458	—	—
Totals	\$137,550,480	\$7,413,286	\$71,091,707	\$4,087,078

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value and classify them in one of three categories described in Note 6 — Fair Value Measurements. The estimated fair value of a security may differ from the amount that could be realized if the security were sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for substantially all of our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. The pricing services do not use broker quotes in determining the fair values of our investments. We review the estimates of fair value provided by the pricing services to determine if the estimates obtained are representative of fair values based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. As of December 31, 2009 and 2008, we received one estimate per security from one of the pricing services, and we priced all but an insignificant amount of our Level 1 and Level 2 investments using those prices. In our review of the estimates provided by the pricing services as of December 31, 2009 and 2008, we did not identify any discrepancies, and we did not make any adjustments to the estimates the pricing services provided. We reclassified one equity security to Level 3 during 2009. We utilized a fair value model that incorporated significant unobservable inputs, such as estimated volatility, to estimate the equity security's fair value.

We had no sales or transfers from the held to maturity portfolio in 2009, 2008 or 2007.

Policy Acquisition Costs

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

Management Evaluation of Operating Results

We believe that principal factors contributing to our earnings over the past several years have been our insurance subsidiaries' overall premium growth, earnings from acquisitions and our insurance subsidiaries' disciplined underwriting practices.

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

(in thousands)	Year Ended December 31,		
	2009	2008	2007
Net premiums written:			
Personal lines:			
Automobile	\$161,932	\$154,091	\$132,452
Homeowners	77,420	72,195	58,602
Other	13,135	13,254	11,299
Total personal lines	252,487	239,540	202,353
Commercial lines:			
Automobile	34,054	35,959	32,059
Workers' compensation	28,921	36,459	32,361
Commercial multi-peril	44,000	49,004	43,559
Other	3,767	3,979	3,357
Total commercial lines	110,742	125,401	111,336
Total net premiums written	\$363,229	\$364,941	\$313,689
Components of GAAP combined ratio:			
Loss ratio	70.7%	64.7%	57.4%
Expense ratio	31.3	32.1	33.5
Dividend ratio	0.2	0.4	0.4
GAAP combined ratio	102.2%	97.2%	91.3%

Revenues:			
Premiums earned:			
Personal lines	\$242,313	\$225,143	\$196,429
Commercial lines	113,233	121,567	113,642
SAP premiums earned	355,546	346,710	310,071
GAAP adjustments	(521)	(135)	—
GAAP premiums earned	355,025	346,575	310,071
Net investment income	20,631	22,756	22,785
Realized investment gains (losses)	4,480	(2,971)	2,051
Other	6,597	5,952	5,711
Total revenues	\$386,733	\$372,312	\$340,618

Components of net income:			
Underwriting income (loss):			
Personal lines	\$ (17,235)	\$ (7,609)	\$ 1,736
Commercial lines	5,805	13,819	22,744
SAP underwriting (loss) income	(11,430)	6,210	24,480
GAAP adjustments	3,636	3,530	2,603
GAAP underwriting (loss) income	(7,794)	9,740	27,083
Net investment income	20,631	22,756	22,785
Realized investment gains (losses)	4,480	(2,971)	2,051
Other	3,360	2,567	930
Income before income taxes	20,677	32,092	52,849
Income taxes	(1,847)	(6,550)	(14,569)
Net income	\$ 18,830	\$ 25,542	\$ 38,280

Results of Operations

Years Ended December 31, 2009 and 2008

Net Premiums Written

Our insurance subsidiaries' 2009 net premiums written decreased slightly to \$363.2 million, compared to \$364.9 million for 2008. Commercial lines net premiums written decreased \$14.7 million, or 11.7%, for 2009 compared to 2008. Personal lines net premiums written increased \$13.0 million, or 5.4%, for 2009 compared to 2008. Net premiums written for 2009 included a \$5.4 million transfer of unearned premium related to Donegal Mutual's affiliation with Southern Mutual. Net premiums written for 2008 included a \$13.6 million transfer of unearned premiums related to the change in the pooling agreement between Atlantic States and Donegal Mutual effective March 1, 2008.

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to \$355.0 million for 2009, an increase of \$8.4 million, or 2.4%, over 2008. Our insurance subsidiaries' net earned premiums during 2009 have grown due to the increase in written premiums during 2008. Our insurance subsidiaries earn premiums and recognize them as income over the terms of the policies they issue. Such terms are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelvemonth period compared to the same period one year earlier.

Investment Income

For 2009, our net investment income was \$20.6 million, a 9.7% decrease from 2008. An increase in our average invested assets from \$619.0 million in 2008 to \$649.5 million in 2009 was offset by a decrease in our annualized average return to 3.2% in 2009, compared to 3.7% in 2008. The decrease in our annualized average rate of return on investments was primarily due to lower reinvestment rates for securities added to our fixed income portfolio during 2009.

Installment Payment Fees

Our insurance subsidiaries' installment fees increased primarily as a result of increases in policy counts during 2009.

Net Realized Investment Gains/Losses

Our net realized investment gains (losses) in 2009 and 2008 were \$4.5 million and (\$3.0) million, respectively. Realized investment gains in 2009 resulted primarily from sales of equity securities as well as fixed maturity investments that had appreciated significantly during the year. Realized investment losses in 2008 included \$2.4 million representing our pro rata share of investment losses in a limited partnership investment that was solely invested in equity securities. We recognized no impairment charges in 2009, compared to impairment charges of \$1.2 million in 2008. Our impairment charges for 2008 were the result of declines in the fair value of equity securities that we determined to be other than temporary. The remaining net realized investment gains and losses in both periods resulted from turnover within our investment portfolio.

Losses and Loss Expenses

Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, was 70.7% in 2009, compared to 64.7% in 2008. Our insurance subsidiaries' commercial lines loss ratio increased to 64.3% in 2009, compared to 56.6% in 2008. This increase primarily resulted from the workers' compensation loss ratio increasing to 75.1% in 2009, compared to 58.9% in 2008, and the commercial automobile loss ratio increasing to 56.4% in 2009, compared to 53.5% in 2008, as a result of increased claim severity and less favorable prior-accident-year loss reserve development. The personal lines loss ratio increased to 73.6% in 2009, compared to 69.1% in 2008, primarily as a result of an increase in the homeowners loss ratio to 78.3% in 2009, compared to 63.0% in 2008, as a result of an increase in weather-related claims and increased property claims from fires.

Underwriting Expenses

Our insurance subsidiaries' expense ratio, which is the ratio of policy acquisition and other underwriting expenses to premiums earned, was 31.3% in 2009, compared to 32.1% in 2008. The decrease in the 2009 expense ratio reflects decreased underwriting-based incentive compensation costs in 2009 compared to 2008 and expense savings initiatives that commenced in the fourth quarter of 2008.

Combined Ratio

Our insurance subsidiaries' combined ratio was 102.2% and 97.2% in 2009 and 2008, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned.

Interest Expense

Our interest expense in 2009 was \$1.7 million, compared to \$1.8 million in 2008. The decrease in interest expense reflected the redemption of \$15.5 million of subordinated debentures in August 2008 and a decrease in average interest rates on our subordinated debentures in 2009 compared to 2008, offset by interest expense related to a premium tax litigation settlement.

Income Taxes

Our income tax expense was \$1.8 million in 2009, compared to \$6.6 million in 2008, representing an effective tax rate of 8.9%, compared to 20.4% in 2008. The change in effective tax rates is primarily due to tax-exempt interest income representing a larger proportion of income before income tax expense in 2009 compared to 2008. We benefited from a 9.9% increase in tax-exempt interest income in 2009 compared to 2008.

Net Income and Earnings Per Share

Our net income in 2009 was \$18.8 million, or \$.76 per share of Class A common stock and \$.68 per share of Class B common stock on a diluted basis, compared to our net income of \$25.5 million, or \$1.02 per share of Class A common stock and \$.92 per share of Class B common stock on a diluted basis, in 2008. Our fully diluted Class A shares outstanding for 2009 decreased slightly to 19.9 million, compared to 20.0 million for December 31, 2008, as a result of our repurchase of treasury stock. Our Class B shares outstanding did not change at 5.6 million.

Book Value Per Share and Return on Equity

Our stockholders' equity increased by \$21.9 million in 2009, primarily as a result of favorable operating results and unrealized gains within our investment portfolio. Book value per share increased by 5.8% to \$15.12 at December 31, 2009, compared to \$14.29 a year earlier. Our return on average equity was 5.0% for 2009, compared to 7.1% for 2008.

Years Ended December 31, 2008 and 2007

Net Premiums Written

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

Net Premiums Earned

Our insurance subsidiaries' net premiums earned increased to \$346.6 million for 2008, an increase of \$36.5 million, or 11.8%, over 2007. Our insurance subsidiaries' net earned premiums during 2008 grew due to the

increase in written premiums during the year. Our insurance subsidiaries earn premiums and recognize them as income over the terms of the policies they issue. Such terms are generally one year or less in duration. Therefore, increases or decreases in net premiums earned will generally reflect increases or decreases in net premiums written in the preceding twelvemonth period compared to the same period one year earlier. Net premiums earned in 2008 reflected the impact of an increased pooling allocation and benefited from the renewal of our 2008 reinsurance program at lower rates compared to 2007.

Investment Income

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

Installment Payment Fees

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

Net Realized Investment Gains/Losses

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

Losses and Loss Expenses

Our insurance subsidiaries' loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, was 64.7% in 2008, compared to 57.3% in 2007. Our insurance subsidiaries' commercial lines loss ratio increased to 56.6% in 2008, compared to 46.8% in 2007. This increase primarily resulted from the workers' compensation loss ratio increasing to 58.9% in 2008, compared to 44.8% in 2007, and the commercial automobile loss ratio increasing to 53.5% in 2008, compared to 49.1% in 2007, as a result of increased claim severity and less favorable prior-accident-year loss reserve development. The personal lines loss ratio increased to 69.1% in 2008, compared to 63.4% in 2007, primarily as a result of an increase in the personal automobile loss ratio to 73.0% in 2008, compared to 66.0% in 2007, as a result of increased claim severity and less favorable prior-accident-year loss reserve development and an increase in the homeowners loss ratio to 63.0% in 2008, compared to 61.8% in 2007, as a result of an increase in weather-related claims.

Underwriting Expenses

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

Combined Ratio

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

Interest Expense

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

Income Taxes

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

Net Income and Earnings Per Share

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

Book Value Per Share and Return on Equity

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

Financial Condition

Liquidity and Capital Resources

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

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement with Donegal Mutual historically has been cash flow positive because of the historical profitability of the underwriting pool. We settle the pool monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We maintain a high degree of liquidity in our investment portfolio in the form of marketable fixed maturities, equity securities and short-term investments. We structure our fixed-maturity investment portfolio following a "laddering" approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations and the obligations of our insurance subsidiaries should an unexpected variation occur in the future. Net cash flows provided by operating activities in 2009, 2008 and 2007, were \$34.1 million, \$52.9 million and \$26.7 million, respectively.

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2009, we have the ability to borrow \$35.0 million at interest rates equal to M&T's current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance

subsidiaries. As of December 31, 2009, we had no borrowings outstanding, and we complied with all requirements of the credit agreement. We intend to extend the credit agreement during 2010.

The following table shows expected payments for our significant contractual obligations as of December 31, 2009:

(in thousands)	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Net liability for unpaid losses and loss expenses	\$180,262	\$82,528	\$81,278	\$7,558	\$ 8,898
Subordinated debentures	15,465	—	—	—	15,465
Total contractual obligations	\$195,727	\$82,528	\$81,278	\$7,558	\$24,363

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

We estimate the timing of the amounts for the subordinated debentures based on their contractual maturities. We may redeem the debentures at our option, at par, as discussed in Note 10 — Borrowings. Our subordinated debentures carry interest rates that vary based upon the three-month LIBOR rate and adjust quarterly. Based upon the interest rates in effect as of December 31, 2009, our annual interest cost associated with our subordinated debentures is approximately \$643,000. For every 1% change in the three-month LIBOR rate, the effect on our annual interest cost would be approximately \$150,000.

Dividends declared to stockholders totaled \$11.2 million, \$10.4 million and \$8.4 million in 2009, 2008 and 2007, respectively. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of dividends from our insurance subsidiaries to us. Our insurance subsidiaries are required to maintain certain minimum surplus on a statutory basis and are subject to regulations under which payment of dividends from statutory surplus is restricted and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2009, each of our insurance subsidiaries had capital substantially above the RBC requirements. In 2010, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities are \$12.4 million from Atlantic States, \$2.8 million from Le Mars, \$3.9 million from Peninsula, \$584,431 from Sheboygan and \$0 from Southern.

Investments

At December 31, 2009 and 2008, our investment portfolio of primarily investment-grade bonds, common stock, short-term investments and cash totaled \$679.8 million and \$634.0 million, respectively, representing 72.7% and 72.1%, respectively, of our total assets.

At December 31, 2009 and 2008, the carrying value of our fixed maturity investments represented 88.7% and 86.3% of our total invested assets, respectively.

Our fixed maturity investments consisted of high-quality marketable bonds, of which 99.0% and 99.5% were rated at investment-grade levels at December 31, 2009 and 2008, respectively. As we invested excess cash from operations and proceeds from maturities of fixed maturity investments during 2009, we increased our holdings of tax-exempt fixed maturity investments in order to obtain more favorable after-tax yields.

At December 31, 2009, the net unrealized gain or loss on available-for-sale fixed maturity investments, net of deferred taxes, amounted to a gain of \$9.2 million, compared to a loss of \$2.1 million at December 31, 2008.

At December 31, 2009, the net unrealized gain on our equity securities, net of deferred taxes, amounted to \$5.8 million, compared to \$3.7 million at December 31, 2008.

Quantitative and Qualitative Disclosures About Market Risk

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

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

Interest Rate Risk

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

Principal cash flows and related weighted-average interest rates by expected maturity dates for financial instruments sensitive to interest rates at December 31, 2009 are as follows:

(in thousands)	Principal Cash Flows	Weighted-Average Interest Rate
Fixed maturity and short-term investments:		
2010	\$ 74,981	1.44%
2011	15,457	4.26
2012	20,476	3.32
2013	20,220	4.22
2014	26,965	4.06
Thereafter	479,472	4.40

Total	\$637,571	
Fair value	\$650,810	
Debt:		
Thereafter	\$ 15,465	4.29%
Total	\$ 15,465	
Fair value	\$ 15,465	

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

Equity Price Risk

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

Credit Risk

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

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

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

Impact of Inflation

Our insurance subsidiaries establish their property and casualty insurance premium rates before they know the amount of losses and loss settlement expenses or the extent to which inflation may impact such expenses. Consequently, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Impact of New Accounting Standards

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 115-2 and Financial Accounting Standard (FAS) 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," codified in FASB Accounting Standards Codification (ASC) section 320-10-65. ASC section 320-10-65 provides guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on debt securities. ASC section 320-10-65 is effective for interim and annual periods ending after June 15, 2009. Effective April 1, 2009, we adopted ASC section 320-10-65. We had no cumulative effect adjustment because we had no debt securities we had determined previously to be other-than-temporarily impaired. Beginning on April 1, 2009, we analyzed our debt securities for other-than-temporary impairment adjustments using the guidance in ASC section 320-10-65.

In April 2009, the FASB issued FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," codified in ASC section 820-10-35. ASC section 820-10-35 provides guidelines for making fair value measurements that are more consistent with the principles presented in FAS 157, "Fair Value Measurements," codified in ASC subtopic 820-10. ASC section 820-10-35 is effective for interim and annual periods ending after June 15, 2009. Effective April 1, 2009, we adopted ASC section 820-10-35. The adoption of ASC section 820-10-35 expanded certain fair value disclosures in our financial statements but had no effect on our results of operations, financial condition or liquidity.

In April 2009, the FASB issued FSP FAS 107-1 and Accounting Principles Board (APB) 28-1, "Interim Disclosures about Fair Value of Financial Instruments," codified in ASC section 825-10-65. ASC section 825-10-65 amends FAS 107, "Disclosures about Fair Value of Financial Instruments," codified in ASC subtopic 825-10, to require disclosures about the fair value of financial instruments for interim periods as well as in annual financial statements. ASC section 825-10-65 is effective for interim and annual periods ending after June 30, 2009. Effective July 1, 2009, we adopted ASC section 825-10-65.

In May 2009, the FASB issued FAS 165, "Subsequent Events," codified in ASC section 855-10-50. ASC section 855-10-50 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before a company issues its financial statements or such statements are available for issuance. ASC section 855-10-50 is effective for interim and annual periods ending after June 15, 2009. Effective June 30, 2009, we adopted ASC section 855-10-50. We have evaluated subsequent events for potential recognition or disclosure.

In June 2009, the FASB issued FAS 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles — a replacement of FASB Statement No. 162," codified in ASC topic 105. On the effective date of this Standard, ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. ASC significantly changes the way financial statement preparers, auditors and academic personnel perform accounting research. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The new standard flattens the GAAP hierarchy to two levels: one that is authoritative (in ASC) and one that is non-authoritative (not in ASC). We began to use the new guidelines and numbering system prescribed by the Codification referring to GAAP in the third quarter of 2009. As the intent of Codification was not to change or alter existing GAAP, the adoption did not impact our financial position or results of operations.

In June 2009, the FASB issued FAS 166, "Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140," codified in ASC subtopic 860-20. FAS 166 amends the derecognition guidance in Statement 140 and eliminates the concept of qualifying special-purpose entities. FAS 166 is effective for fiscal years and interim periods beginning after November 15, 2009. We adopted FAS 166 on January 1, 2010 but have not yet determined the effect of its adoption on our consolidated financial statements.

In June 2009, the FASB issued FAS 167, "Amendments to FASB Interpretation No. 46(R)," which amends the consolidation guidance applicable to variable interest entities ("VIEs") and is codified in ASC subtopic 810-10. An entity would consolidate a VIE, as the primary beneficiary, when the entity has both of the following characteristics: (a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (b) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. FAS 167 requires ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE. FAS 167 amends FASB Interpretation No. 46(R) to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE. FAS 167 is effective for fiscal years and interim periods beginning after November 15, 2009. We adopted FAS 167 on January 1, 2010 but have not yet determined the effect of its adoption on our consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, "Improving Disclosures about Fair Value Measurements." ASU 2010-06 provides amendments to ASC subtopic 820-10 requiring new and clarifying existing fair value disclosures. ASU 2010-06 is effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. We will adopt ASU 2010-06 on January 1, 2011 and have not yet determined the effect of its adoption on our consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

December 31,	2009	2008
Assets		
Investments		
Fixed maturities		
Held to maturity, at amortized cost (fair value \$77,005,740 and \$101,449,024)	\$ 73,807,126	\$ 99,878,156
Available for sale, at fair value (amortized cost \$503,745,585 and \$449,009,842)	517,703,672	445,815,749
Equity securities, available for sale, at fair value (cost \$3,804,064 and \$2,939,236)	9,914,626	5,894,975
Investments in affiliates	9,309,347	8,594,177
Short-term investments, at cost, which approximates fair value	56,100,415	71,952,469
Total investments	666,835,186	632,135,526
Cash	12,923,898	1,830,954
Accrued investment income	6,202,710	6,655,506
Premiums receivable	61,187,021	55,337,270
Reinsurance receivable	84,670,009	79,952,971
Deferred policy acquisition costs	32,844,179	29,541,281
Deferred tax asset, net	5,086,949	10,994,644
Prepaid reinsurance premiums	56,040,728	51,436,487
Property and equipment, net	6,592,223	6,686,684
Accounts receivable — securities	588,292	862,790
Federal income taxes recoverable	663,047	2,590,928
Other	1,967,685	2,083,995
Total assets	\$935,601,927	\$880,109,036
Liabilities and Stockholders' Equity		
Liabilities		
Losses and loss expenses	\$263,598,844	\$239,809,276
Unearned premiums	241,821,419	229,013,929
Accrued expenses	10,578,695	14,149,754
Reinsurance balances payable	2,561,426	1,566,816
Cash dividends declared to stockholders	2,798,378	2,602,104
Subordinated debentures	15,465,000	15,465,000
Accounts payable — securities	6,828,873	1,820,574
Due to affiliate	3,813,294	3,148,057
Drafts payable	884,993	876,210
Due to Sheboygan policyholders	316,927	6,843,454
Other	1,428,379	1,229,997
Total liabilities	550,096,228	516,525,171
Stockholders' Equity		
Preferred stock, \$1.00 par value, authorized 2,000,000 shares; none issued	—	—
Class A common stock, \$.01 par value, authorized 30,000,000 shares, issued 20,569,930 and 20,494,764 shares and outstanding 19,917,331 and 19,869,065 shares	205,700	204,948
Class B common stock, \$.01 par value, authorized 10,000,000 shares, issued 5,649,240 shares and outstanding 5,576,775 shares	56,492	56,492
Additional paid-in capital	164,585,214	163,136,938
Accumulated other comprehensive income	15,007,044	1,713,836
Retained earnings	214,755,495	207,182,253
Treasury stock, at cost	(9,104,246)	(8,710,602)
Total stockholders' equity	385,505,699	363,583,865
Total liabilities and stockholders' equity	\$935,601,927	\$880,109,036

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

Year Ended December 31,

2009

2008

2007

Statements of Income

Revenues			
Net premiums earned (includes affiliated reinsurance of \$128,747,699, \$130,067,404 and \$107,045,158 — see footnote 3)	\$355,025,477	\$346,575,266	\$310,071,534
Investment income, net of investment expenses	20,630,583	22,755,784	22,785,252
Installment payment fees	5,205,109	5,025,138	4,650,139
Lease income	921,583	926,690	1,060,319
Net realized investment gains (losses)	4,479,558	(2,970,716)	2,051,050
Other	471,097	112,065	—
Total revenues	386,733,407	372,424,227	340,618,294
Expenses			
Net losses and loss expenses (includes affiliated reinsurance of \$68,712,989, \$85,598,098 and \$70,676,398 — see footnote 3)	250,835,396	224,300,964	177,783,632
Amortization of deferred policy acquisition costs	60,292,000	58,250,000	51,205,000
Other underwriting expenses	50,843,464	53,108,436	52,726,155
Policy dividends	848,882	1,175,809	1,273,323
Interest	1,746,509	1,821,229	2,884,861
Other	1,490,467	1,675,745	1,896,385
Total expenses	366,056,718	340,332,183	287,769,356
Income before income tax expense	20,676,689	32,092,044	52,848,938
Income tax expense	1,846,611	6,550,066	14,569,033
Net income	\$ 18,830,078	\$ 25,541,978	\$ 38,279,905
Basic earnings per common share:			
Class A common stock	\$ 0.76	\$ 1.03	\$ 1.55
Class B common stock	\$ 0.68	\$ 0.92	\$ 1.39
Diluted earnings per common share:			
Class A common stock	\$ 0.76	\$ 1.02	\$ 1.53
Class B common stock	\$ 0.68	\$ 0.92	\$ 1.39

Statements of Comprehensive Income

Net income	\$ 18,830,078	\$ 25,541,978	\$ 38,279,905
Other comprehensive income (loss), net of tax			
Unrealized gains (losses) on securities:			
Unrealized holding gain (loss) arising during the period, net of income tax (benefit) of \$8,680,941, (\$3,872,368) and \$1,748,072	16,249,716	(7,191,540)	3,246,420
Reclassification adjustment for (gains) losses included in net income, net of income tax (benefit) of \$1,523,050, (\$1,039,751) and \$717,867	(2,956,508)	1,930,965	(1,333,183)
Other comprehensive income (loss)	13,293,208	(5,260,575)	1,913,237
Comprehensive income	\$ 32,123,286	\$ 20,281,403	\$ 40,193,142

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock				Additional Paid-In Capital	Accumulated Other Comprehensive Income	Retained Earnings	Treasury Stock	Total Stockholders' Equity
	Class A Shares	Class B Shares	Class A Amount	Class B Amount					
Balance, January 1, 2007	19,834,248	5,649,240	\$198,342	\$56,492	\$152,391,301	\$ 5,061,174	\$163,986,701	\$ (891,748)	\$320,802,262
Issuance of common stock (stock compensation plans)	333,751		3,338		3,539,241				3,542,579
Net income							38,279,905		38,279,905
Cash dividends							(8,394,572)		(8,394,572)
Grant of stock options					65,179		(65,179)		—
Tax benefit on exercise of stock options					854,945				854,945
Purchase of treasury stock								(4,308,165)	(4,308,165)
Other comprehensive income						1,913,237			1,913,237
Balance, December 31, 2007	20,167,999	5,649,240	\$201,680	\$56,492	\$156,850,666	\$ 6,974,411	\$193,806,855	\$ (5,199,913)	\$352,690,191
Issuance of common stock (stock compensation plans)	326,765		3,268		3,853,328				3,856,596
Net income							25,541,978		25,541,978
Cash dividends							(10,417,517)		(10,417,517)
Grant of stock options					1,749,063		(1,749,063)		—
Tax benefit on exercise of stock options					683,881				683,881
Purchase of treasury stock								(3,510,689)	(3,510,689)
Other comprehensive loss						(5,260,575)			(5,260,575)
Balance, December 31, 2008	20,494,764	5,649,240	\$204,948	\$56,492	\$163,136,938	\$ 1,713,836	\$207,182,253	\$ (8,710,602)	\$363,583,865
Issuance of common stock (stock compensation plans)	75,166		752		1,385,285				1,386,037
Net income							18,830,078		18,830,078
Cash dividends							(11,193,845)		(11,193,845)
Grant of stock options					62,991		(62,991)		—
Purchase of treasury stock								(393,644)	(393,644)
Other comprehensive income						13,293,208			13,293,208
Balance, December 31, 2009	20,569,930	5,649,240	\$205,700	\$56,492	\$164,585,214	\$15,007,044	\$214,755,495	\$ (9,104,246)	\$385,505,699

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31,	2009	2008	2007
Cash Flows from Operating Activities:			
Net income	\$ 18,830,078	\$ 25,541,978	\$ 38,279,905
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,552,186	2,401,345	2,446,126
Net realized investment (gains) losses	(4,479,558)	2,970,716	(2,051,050)
Equity (income) loss	(471,097)	(112,065)	182,502
Changes in Assets and Liabilities:			
Losses and loss expenses	23,789,568	9,952,760	(32,590,057)
Unearned premiums	12,807,490	22,477,395	6,527,588
Accrued expenses	(3,571,059)	966,958	(440,584)
Premiums receivable	(5,849,751)	(3,173,057)	(1,089,799)
Deferred policy acquisition costs	(3,302,898)	(3,306,209)	(1,496,143)
Deferred income taxes	(1,250,187)	(832,628)	1,029,042
Reinsurance receivable	(4,717,038)	204,249	18,779,861
Accrued investment income	452,796	(668,682)	(105,821)
Amounts due to/from affiliate	665,237	2,906,139	(1,325,173)
Reinsurance balances payable	994,610	(636,074)	70,529
Prepaid reinsurance premiums	(4,604,241)	(4,111,609)	(2,909,383)
Current income taxes	1,927,881	(2,618,163)	1,374,521
Other, net	323,491	898,872	152,805
Net adjustments	15,267,430	27,319,947	(11,445,036)
Net cash provided by operating activities	34,097,508	52,861,925	26,834,869
Cash Flows from Investing Activities:			
Purchase of fixed maturities			
Available for sale	(158,409,231)	(204,882,809)	(43,360,830)
Purchase of equity securities	(39,163,607)	(45,091,418)	(29,316,342)
Sale of fixed maturities			
Available for sale	62,668,210	28,971,515	—
Maturity of fixed maturities			
Held to maturity	25,617,925	53,830,674	14,222,283
Available for sale	48,363,915	69,699,141	40,206,090
Sale of equity securities	39,638,895	71,177,458	30,160,998
Payments to Sheboygan policyholders	(6,526,527)	(3,352,938)	—
Net (increase) decrease in investment in affiliates	(100,000)	464,000	(50,000)
Net purchase of property and equipment	(941,020)	(1,222,246)	(1,363,622)
Net sales (purchases) of short-term investments	15,852,054	(453,790)	(25,037,964)
Net cash used in investing activities	(12,999,386)	(30,860,413)	(14,539,387)
Cash Flows from Financing Activities:			
Issuance of common stock	1,386,037	3,856,596	3,542,579
Redemption of subordinated debentures	—	(15,464,000)	—
Cash dividends paid	(10,997,571)	(10,025,711)	(8,627,232)
Purchase of treasury stock	(393,644)	(3,510,689)	(4,308,165)
Tax benefit on exercise of stock options	—	683,881	854,945
Net cash used in financing activities	(10,005,178)	(24,459,923)	(8,537,873)
Net increase (decrease) in cash	11,092,944	(2,458,411)	3,757,609
Cash at beginning of year	1,830,954	4,289,365	531,756
Cash at end of year	\$ 12,923,898	\$ 1,830,954	\$ 4,289,365

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1 — Summary of Significant Accounting Policies

Organization and Business

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

At December 31, 2009, Donegal Mutual owned approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock. Our insurance subsidiaries and Donegal Mutual have interrelated operations. While each company maintains its separate corporate existence, our insurance subsidiaries and Donegal Mutual conduct business together as the Donegal Insurance Group. As such, Donegal Mutual and our insurance subsidiaries share the same business philosophy, the same management, the same employees and the same facilities and offer the same types of insurance products.

Atlantic States, our largest subsidiary, participates in a pooling agreement with Donegal Mutual. Under the pooling agreement, Donegal Mutual and Atlantic States pool substantially all of their insurance business. Donegal Mutual then cedes 80% of the pooled business to Atlantic States. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States' share of the pooled business to 80%.

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

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

In October 2009, Donegal Mutual consummated an affiliation with Southern Mutual Insurance Company ("Southern Mutual"), pursuant to which Donegal Mutual purchased a surplus note of Southern Mutual in the principal amount of \$2.5 million, Donegal Mutual designees became a majority of the members of Southern Mutual's board of directors, and Donegal Mutual agreed to provide quota share reinsurance to Southern Mutual for 100% of its business. Effective October 31, 2009, Donegal Mutual began to include business assumed from Southern Mutual in its pooling agreement with Atlantic States. Southern Mutual writes primarily personal lines of insurance in Georgia and South Carolina and had direct premiums written of approximately \$13.3 million in 2009. Pursuant to applicable accounting standards, Southern Mutual is a variable interest entity, of which we are not the primary beneficiary.

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

Basis of Consolidation

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

Use of Estimates

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

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

Reclassification

We have reclassified certain amounts in 2009 as reported in our Consolidated Statements of Income and Consolidated Statements of Cash Flows to conform to the current year presentation.

Investments

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

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

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

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we write down the investment to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of original cost and has been in such an unrealized loss position for more than six months. As of April 1, 2009, we adopted new accounting guidance related to the accounting for and presentation of impairment losses on debt securities as discussed in Note 2 — Impact of New Accounting Standards. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades.

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

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

We account for investments in affiliates using the equity method of accounting. Under the equity method, we record our investment at cost, with adjustments for our share of the affiliate's earnings and losses as well as changes in the affiliate's equity due to unrealized gains and losses.

Fair Values of Financial Instruments

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

Investments—We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security were sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for substantially all of our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. The pricing services do not use broker quotes in determining the fair values of our investments. We review the estimates of fair value provided by the pricing services to determine if the estimates obtained are representative of fair values based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. See Note 6 — Fair Value Measurements for more information regarding our methods and assumptions in estimating fair values.

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

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

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

Revenue Recognition

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

Policy Acquisition Costs

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

Property and Equipment

We report property and equipment at depreciated cost that we compute using the straight-line method based upon estimated useful lives of the assets.

Losses and Loss Expenses

Liabilities for losses and loss expenses are estimates at a given point in time of the amounts an insurer expects to pay with respect to policyholder claims based on facts and circumstances then known. An insurer recognizes at the time of establishing its estimates that its ultimate liability for losses and loss expenses will exceed or be less than such estimates. We base our insurance subsidiaries' estimates of

liabilities for losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors. However, during the loss adjustment period, our insurance subsidiaries may learn additional facts regarding individual claims, and consequently it often becomes necessary for our insurance subsidiaries to refine and adjust their estimates of liability. We reflect any adjustments to our insurance subsidiaries' liabilities for losses and loss expenses in our operating results in the period in which we make the changes in estimates.

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

Reserve estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries' external environment and, to a lesser extent, assumptions as to our insurance subsidiaries' internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on workers' compensation claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on workers' compensation claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include consistency in the recording of premium and loss statistics, consistency in the recording of claims, payment and case reserving methodology, accurate measurement of the impact of rate changes and changes in policy provisions, consistency in the quality and characteristics of business written within a given line of business and consistency in reinsurance coverage and collectibility of reinsured losses, among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries attempt to make appropriate adjustments for such changes in their reserves. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded.

Our insurance subsidiaries seek to enhance their underwriting results by carefully selecting the product lines they underwrite. Our insurance subsidiaries' personal lines products include standard and preferred risks in private passenger automobile and homeowners lines. Our insurance subsidiaries commercial lines products primarily include mercantile risks, business offices, wholesalers, service providers and artisan risks, avoiding industrial and manufacturing exposures. Our insurance subsidiaries have limited exposure to asbestos and other environmental liabilities. Our insurance subsidiaries write no medical malpractice or other professional liability risks.

Income Taxes

We currently file a consolidated federal income tax return.

We account for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities at enacted tax rates expected to be in effect when we realize or settle such amounts.

Credit Risk

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

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

Our insurance subsidiaries have reinsurance agreements with Donegal Mutual and with a number of other authorized reinsurers with at least an A.M. Best rating of A- or an equivalent financial condition.

Reinsurance Accounting and Reporting

Our insurance subsidiaries rely upon reinsurance agreements to limit their maximum net loss from large single risks or risks in concentrated areas and to increase their capacity to write insurance. Reinsurance does not relieve our insurance subsidiaries from liability to their respective policyholders. To the extent that a reinsurer cannot pay losses for which it is liable under the terms of a reinsurance agreement, our insurance subsidiaries retain continued liability for such losses. However, in an effort to reduce the risk of non-payment, our insurance subsidiaries require all of their reinsurers to have an A.M. Best rating of A- or better or, with respect to foreign reinsurers, to have a financial condition that, in the opinion of management, is equivalent to a company with at least an A- rating from A.M. Best. See Note 11 — Reinsurance for more information regarding our reinsurance agreements.

Stock-Based Compensation

We measure all share-based payments to employees, including grants of stock options, using a fair-value-based method and record such expense in our results of operations. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, we estimate the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilize in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility.

We classified tax benefits realized upon the exercise of stock options of \$0, \$683,881 and \$854,945 for the years ended December 31, 2009, 2008 and 2007, respectively, as financing activities in our consolidated statements of cash flows.

Earnings per Share

We calculate basic earnings per share by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than those declared and paid on our Class B common stock. Accordingly, we use the

share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class.

2 — Impact of New Accounting Standards

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 115-2 and Financial Accounting Standard (FAS) 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," codified in FASB Accounting Standards Codification (ASC) section 320-10-65. ASC section 320-10-65 provides guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on debt securities. ASC section 320-10-65 is effective for interim and annual periods ending after June 15, 2009. Effective April 1, 2009, we adopted ASC section 320-10-65. We had no cumulative effect adjustment because we had no debt securities determined previously to be other-than-temporarily impaired. Beginning on April 1, 2009, we analyzed our debt securities for other-than-temporary impairment adjustments using the guidance in ASC section 320-10-65.

In April 2009, the FASB issued FSP FAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," codified in ASC section 820-10-35. ASC section 820-10-35 provides guidelines for making fair value measurements that are more consistent with the principles presented in FAS 157, "Fair Value Measurements," codified in ASC subtopic 820-10. ASC section 820-10-35 is effective for interim and annual periods ending after June 15, 2009. Effective April 1, 2009, we adopted ASC section 820-10-35. The adoption of ASC section 820-10-35 expanded certain fair value disclosures in our financial statements but had no effect on our results of operations, financial condition or liquidity.

In April 2009, the FASB issued FSP FAS 107-1 and Accounting Principles Board (APB) 28-1, "Interim Disclosures about Fair Value of Financial Instruments," codified in ASC section 825-10-65. ASC section 825-10-65 amends FAS 107, "Disclosures about Fair Value of Financial Instruments," codified in ASC subtopic 825-10, to require disclosures about fair value of financial instruments for interim periods as well as in annual financial statements. ASC section 825-10-65 is effective for interim and annual periods ending after June 30, 2009. Effective July 1, 2009, we adopted ASC section 825-10-65.

In May 2009, the FASB issued FAS 165, "Subsequent Events," codified in ASC section 855-10-50. ASC section 855-10-50 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. ASC section 855-10-50 is effective for interim and annual periods ending after June 15, 2009. Effective June 30, 2009, we adopted ASC section 855-10-50. We have evaluated subsequent events for potential recognition or disclosure.

In June 2009, the FASB issued FAS 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles — a replacement of FASB Statement No. 162," codified in ASC topic 105. On the effective date of this Standard, ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. ASC significantly changes the way financial statement preparers, auditors and academic personnel perform accounting research. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The new standard flattens the GAAP hierarchy to two levels: one that is authoritative (in ASC) and one that is non-authoritative (not in ASC). We began to use the new guidelines and numbering system prescribed by the Codification referring to GAAP in the third quarter of 2009. As the intent of Codification was not to change or alter existing GAAP, the adoption did not impact our financial position or results of operations.

In June 2009, the FASB issued FAS 166, "Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140," codified in ASC subtopic 860-20. FAS 166 amends the derecognition guidance in Statement 140 and eliminates the concept of qualifying special-purpose entities ("QSPEs"). FAS 166 is effective for fiscal years and interim periods beginning after November 15, 2009. We adopted FAS 166 on January 1, 2010 but have not yet determined the effect of its adoption on our consolidated financial statements.

In June 2009, the FASB issued FAS 167, "Amendments to FASB Interpretation No. 46(R)," which amends the consolidation guidance applicable to variable interest entities ("VIEs") and is codified in ASC subtopic 810-10. An entity would consolidate a VIE, as the primary beneficiary, when the entity has both of the following characteristics: (a) the power to direct the activities of a VIE that most significantly impact the entity's economic performance and (b) the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. FAS 167 requires ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE. FAS 167 amends FASB Interpretation No. 46(R) to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE. FAS 167 is effective for fiscal years and interim periods beginning after November 15, 2009. We adopted FAS 167 on January 1, 2010 but have not yet determined the effect of its adoption on our consolidated financial statements.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, "Improving Disclosures about Fair Value Measurements." ASU 2010-06 provides amendments to ASC subtopic 820-10 requiring new and clarifying existing fair value disclosures. ASU 2010-06 is effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. We will adopt ASU 2010-06 on January 1, 2011 and have not yet determined the effect of its adoption on our consolidated financial statements.

3 — Transactions with Affiliates

Our insurance subsidiaries conduct business and have various agreements with Donegal Mutual that are described below:

a. Reinsurance Pooling and Other Reinsurance Arrangements

Atlantic States, our largest subsidiary, and Donegal Mutual have a pooling agreement under which both companies pool substantially all of their respective premiums, losses and loss expenses and receive an allocated percentage of their combined underwriting results. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States's share of the results of the pool to 80%. The intent of the pooling agreement is to produce more uniform and stable underwriting results from year to year for each pool participant than they would experience individually and to spread the risk of loss between the participants based on each participant's relative amount of surplus and relative access to capital. Each participant in the pool has at its disposal the capacity of the entire pool, rather than being limited to policy exposures of a size commensurate with its own capital and surplus.

The following amounts represent reinsurance Atlantic States ceded to the pool during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$96,502,445	\$93,336,444	\$86,026,309
Losses and loss expenses	\$68,248,082	\$54,407,168	\$42,017,980
Prepaid reinsurance premiums	\$52,199,831	\$48,448,624	\$45,275,947
Liability for losses and loss expenses	\$55,396,390	\$45,777,168	\$46,226,796

The following amounts represent reinsurance Atlantic States assumed from the pool during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$223,223,583	\$220,641,805	\$193,690,192
Losses and loss expenses	\$138,058,878	\$140,969,892	\$109,118,227
Unearned premiums	\$117,044,000	\$110,064,380	\$ 95,691,236
Liability for losses and loss expenses	\$131,247,578	\$121,366,321	\$113,458,587

Donegal Mutual and Southern have a quota-share reinsurance agreement whereby Southern assumes 100% of the premiums and losses related to personal lines products Donegal Mutual offers in Virginia through the use of its automated policy quoting and issuance system. Donegal Mutual and Le Mars have a quota-share reinsurance agreement whereby Le Mars assumes 100% of the premiums and losses related to certain products offered in certain Midwest states by Donegal Mutual, which provide the availability of complementary products to Le Mars' commercial accounts. The following amounts represent reinsurance Southern and Le Mars assumed from Donegal Mutual pursuant to the quota-share reinsurance agreements during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$12,856,983	\$9,690,726	\$5,378,608
Losses and loss expenses	\$10,987,391	\$7,612,090	\$3,797,947
Unearned premiums	\$ 6,998,285	\$6,064,734	\$4,101,974
Liability for losses and loss expenses	\$ 4,868,486	\$2,672,698	\$1,152,041

Donegal Mutual and Peninsula have a quota-share reinsurance agreement whereby Donegal Mutual assumes 100% of the premiums and losses related to the workers' compensation product line of Peninsula in certain states. Prior to January 1, 2002, Donegal Mutual and Southern had a quota-share agreement whereby Southern ceded 50% of its direct business, less reinsurance, to Donegal Mutual. The business assumed by Donegal Mutual becomes part of the pooling agreement between Donegal Mutual and Atlantic States. The following amounts represent reinsurance ceded to Donegal Mutual pursuant to the quota-share reinsurance agreements during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$2,515,075	\$880,017	\$ 457,074
Losses and loss expenses	\$2,342,895	\$697,929	\$(165,655)
Prepaid reinsurance premiums	\$1,855,076	\$889,993	\$ 60,961
Liability for losses and loss expenses	\$1,980,626	\$679,718	\$ 836,031

Atlantic States, Southern and Le Mars each have a catastrophe reinsurance agreement with Donegal Mutual that limits the maximum liability under any one catastrophic occurrence to \$1,000,000, \$750,000 and \$500,000, respectively, with a combined limit of \$1,800,000 for a catastrophe involving a combination of these subsidiaries. Donegal Mutual and Southern have an excess of loss reinsurance agreement in which Donegal Mutual assumes up to \$350,000 (\$300,000 in 2008 and \$150,000 in 2007) of losses in excess of \$400,000 (\$300,000 in 2008 and \$250,000 in 2007). Donegal Mutual and Sheboygan had an excess of loss reinsurance agreement during 2009 in which Donegal Mutual assumed up to \$50,000 of losses in excess of \$150,000. The following amounts represent reinsurance ceded to Donegal Mutual pursuant to these reinsurance agreements during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$8,315,347	\$5,508,666	\$5,540,259
Losses and loss expenses	\$9,742,303	\$7,878,787	\$ 387,451
Liability for losses and loss expenses	\$3,268,129	\$5,456,611	\$3,171,245

The following amounts represent the effect of affiliated reinsurance transactions on net premiums our insurance subsidiaries earned during 2009, 2008 and 2007:

	2009	2008	2007
Assumed	\$ 236,080,566	\$230,332,531	\$199,068,800
Ceded	(107,332,867)	(99,725,127)	(92,023,642)
Net	\$ 128,747,699	\$130,607,404	\$107,045,158

The following amounts represent the effect of affiliated reinsurance transactions on net losses and loss expenses our insurance subsidiaries incurred during 2009, 2008 and 2007:

	2009	2008	2007
Assumed	\$149,046,269	\$148,581,982	\$112,916,174
Ceded	(80,333,280)	(62,983,884)	(42,239,776)
Net	\$ 68,712,989	\$ 85,598,098	\$ 70,676,398

b. Expense Sharing

Donegal Mutual provides facilities, management and other services to us and our insurance subsidiaries. Donegal Mutual allocates certain related expenses to Atlantic States in relation to the relative participation of Atlantic States and Donegal Mutual in the pooling agreement. Our insurance subsidiaries other than Atlantic States reimburse Donegal Mutual for their personnel costs and bear their proportionate share of

information services costs based on their percentage of total written premiums of the Donegal Insurance Group. Charges for these services totalled \$60,175,789, \$56,819,869 and \$52,268,253 for 2009, 2008 and 2007, respectively.

c. Lease Agreement

We lease office equipment and automobiles with terms ranging from 3 to 10 years to Donegal Mutual under a 10-year lease agreement dated January 1, 2000.

d. Legal Services

Donald H. Nikolaus, our President and one of our directors, is a partner in the law firm of Nikolaus & Hohenadel. Such firm has served as our general counsel since 1986, principally in connection with the defense of claims litigation arising in Lancaster, Dauphin and York counties of Pennsylvania. We pay such firm its customary fees for such services.

e. Province Bank

As of December 31, 2009 and 2008, we had \$10,163,195 and \$2,063,569, respectively, in checking accounts with Province Bank, a wholly owned subsidiary of DFSC. We earned \$3,260, \$133,251 and \$210,654 in interest on these accounts during 2009, 2008 and 2007, respectively.

4 — Business Combinations

During 2008, we acquired all of the outstanding stock of Sheboygan. We accounted for this acquisition as a business combination.

In December 2006, Donegal Mutual consummated an affiliation with Sheboygan. As part of the affiliation, Donegal Mutual entered into a management agreement with and purchased a \$3.5 million surplus note issued by Sheboygan. During 2007, Sheboygan's board of directors adopted a plan of conversion to convert to a stock insurance company. Following policyholder and regulatory approval of the plan of conversion, we acquired all of the outstanding stock of Sheboygan as of December 1, 2008 for approximately \$12.0 million in cash, including payment of the principal amount of the surplus note (\$3.5 million) and accrued interest (\$32,171) to Donegal Mutual. The payment also included a surplus contribution (\$8.5 million) to Sheboygan to support future premium growth. Sheboygan's results of operations have been included in our consolidated results from December 1, 2008. At December 31, 2009 and 2008, Sheboygan had amounts due to policyholders pursuant to the plan of conversion of \$316,927 and \$6.8 million, respectively.

The acquisition of Sheboygan enabled us to extend our insurance business to Wisconsin. Sheboygan, organized under the laws of Wisconsin in 1899, operates as a property and casualty insurer in Wisconsin. Personal lines coverages represent a majority of Sheboygan's premiums written, with the balance coming from farmowners and mercantile and service businesses. Sheboygan's largest lines of business are homeowners, private passenger automobile liability and physical damage. For the years ended December 31, 2008 and 2007, Sheboygan had net premiums earned of \$7.9 million and \$7.7 million, respectively. For the years ended December 31, 2008 and 2007, Sheboygan had a statutory net (loss) income of (\$1.1) million, and \$632,202, respectively. Sheboygan's total admitted assets on a statutory basis as of December 31, 2008 and 2007 were \$25.7 million and \$17.5 million, respectively. Sheboygan's surplus on a statutory basis as of December 31, 2008 and 2007 was \$11.2 million and \$10.6 million, respectively. Net loss for 2008 and all amounts for 2007 are unaudited. We based the purchase price of Sheboygan upon an independent valuation of Sheboygan as of September 30, 2008.

5 — Investments

The amortized cost and estimated fair values of fixed maturities and equity securities at December 31, 2009 and 2008 are as follows:

2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 2,000,000	\$ 80,260	\$ —	\$ 2,080,260
Obligations of states and political subdivisions	61,736,351	3,011,092	24,034	64,723,409
Corporate securities	6,243,138	72,300	13,034	6,302,404
Residential mortgage-backed securities	3,827,637	72,059	29	3,899,667
Totals	\$73,807,126	\$3,235,711	\$37,097	\$77,005,740

2009				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 41,061,366	\$ 154,076	585,363	\$ 40,630,079
Obligations of states and political subdivisions	346,798,545	12,587,395	1,019,462	358,366,478
Corporate securities	26,971,526	866,136	71,859	27,765,803
Residential mortgage-backed securities	88,914,148	2,356,647	329,483	90,941,312
Fixed maturities	503,745,585	15,964,254	2,006,167	517,703,672
Equity securities	3,804,064	6,338,360	227,798	9,914,626
Totals	\$507,549,649	\$22,302,614	\$2,233,965	\$527,618,298

2008				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 8,516,714	\$ 176,071	\$ —	\$ 8,692,785
Obligations of states and political subdivisions	76,450,762	1,954,867	231,545	78,174,084
Corporate securities	8,341,519	57,124	391,701	8,006,942
Residential mortgage-backed securities	6,569,161	35,256	29,204	6,575,213
Totals	\$99,878,156	\$2,223,318	\$652,450	\$101,449,024

2008				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 6,525,568	\$ 104,732	—	\$ 6,630,300
Obligations of states and political subdivisions	341,662,882	5,320,541	9,980,590	337,002,833
Corporate securities	24,517,546	208,337	790,169	23,935,714
Residential mortgage-backed securities	76,303,846	1,960,753	17,697	78,246,902
Fixed maturities	449,009,842	7,594,363	10,788,456	445,815,749
Equity securities	2,939,236	3,015,197	59,458	5,894,975
Totals	\$451,949,078	\$10,609,560	\$10,847,914	\$451,710,724

The amortized cost and estimated fair value of fixed maturities at December 31, 2009, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
Held to maturity		
Due in one year or less	\$ 4,500,006	\$ 4,555,420
Due after one year through five years	6,014,660	6,170,132
Due after five years through ten years	56,119,315	58,971,616
Due after ten years	3,345,508	3,408,905
Mortgage-backed securities	3,827,637	3,899,667
Total held to maturity	\$ 73,807,126	\$ 77,005,740
Available for sale		
Due in one year or less	\$ 11,664,381	\$ 11,910,987
Due after one year through five years	73,398,473	75,384,290
Due after five years through ten years	106,810,216	110,232,681
Due after ten years	222,958,367	229,234,402
Mortgage-backed securities	88,914,148	90,941,312
Total available for sale	\$503,745,585	\$517,703,672

The amortized cost of fixed maturities on deposit with various regulatory authorities at December 31, 2009 and 2008 amounted to \$9,761,979 and \$9,189,695, respectively.

Investments in affiliates consisted of the following at December 31, 2009 and 2008:

	2009	2008
DFSC	\$8,844,347	\$8,129,177
Other	465,000	465,000
Total	\$9,309,347	\$8,594,177

We made additional equity investments in DFSC in the amounts of \$100,000 and \$0 during 2009 and 2008, respectively. Other income and expenses in our consolidated statements of income include income (expenses) of \$471,097, \$112,065 and (\$182,502) for 2009, 2008 and 2007, respectively, representing our share of DFSC's income or loss. In addition, other comprehensive income (loss) in our statements of comprehensive income includes net unrealized gains of \$93,647, \$193,241 and \$206,871 for 2009, 2008 and 2007, respectively, representing our share of DFSC's unrealized investment gains.

Other investment in affiliates represents our investment in statutory trusts that hold our subordinated debentures as discussed in Note 10 — Borrowings.

We derive net investment income, consisting primarily of interest and dividends, from the following sources:

	2009	2008	2007
Fixed maturities	\$24,458,118	\$23,379,999	\$21,670,399
Equity securities	69,287	552,575	853,960
Short-term investments	199,735	1,079,325	2,146,342
Other	47,514	36,008	34,214
Investment income	24,774,654	25,047,907	24,704,915
Investment expenses	(4,144,071)	(2,292,123)	(1,919,663)
Net investment income	\$20,630,583	\$22,755,784	\$22,785,252

Gross realized gains and losses from investments and the change in the difference between fair value and cost of investments, before applicable income taxes, are as follows:

	2009	2008	2007
Gross realized gains:			
Fixed maturities	\$ 2,654,648	\$ 1,641,249	\$ 246,959
Equity securities	2,179,331	2,397,716	2,830,592
	4,833,979	4,038,965	3,077,551
Gross realized losses:			
Fixed maturities	102,143	311,900	11,286
Equity securities	252,278	6,697,781	1,015,215
	354,421	7,009,681	1,026,501
Net realized gains (losses)	\$ 4,479,558	\$ (2,970,716)	\$2,051,050
Change in difference between fair value and cost of investments:			
Fixed maturities	\$18,779,926	\$ (7,235,434)	\$5,132,415
Equity securities	3,154,823	(3,440,944)	(639,612)
Totals	\$21,934,749	\$(10,676,378)	\$4,492,803

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2009 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S.	\$26,703,601	\$ 585,364	\$ —	\$ —

government corporations and agencies				
Obligations of states and political subdivisions	17,971,018	256,527	29,582,488	786,970
Corporate securities	1,284,405	23,525	666,941	61,366
Residential mortgage- backed securities	23,514,855	328,969	477,421	543
Equity securities	2,139,457	227,798	—	—
Totals	\$71,613,336	\$1,422,183	\$30,726,850	\$848,879

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

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ —	\$ —	\$ —	\$ —
Obligations of states and political subdivisions	117,360,120	6,880,692	65,626,857	3,331,443
Corporate securities	16,780,992	448,760	2,536,165	733,109
Residential mortgage- backed securities	2,925,368	24,376	2,928,685	22,526
Equity securities	484,000	59,458	—	—
Totals	\$137,550,480	\$7,413,286	\$71,091,707	\$4,087,078

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, we write down the investment to its fair value and we reflect the amount of the write-down as a realized loss in our results of operations when we consider the decline in value of an individual investment to be other than temporary. We individually monitor all investments for other-than-temporary declines in value. Generally, we assume there has been an other-than-temporary decline in value if an individual equity security has depreciated in value by more than 20% of original cost and has been in such an unrealized loss position for more than six months. We held five equity securities that were in an unrealized loss position at December 31, 2009. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we considered these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we determine we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the debt security prior to recovery. If we determine it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If we determine it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. We determine whether a credit loss has occurred by comparing the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider that a credit loss has occurred. If we determine that a credit loss occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including when the fair value of an investment is significantly below its cost, when the financial condition of the issuer of a security has deteriorated, the occurrence of industry, company or geographic events that have negatively impacted the value of a security and rating agency downgrades. We held 73 debt securities that were in an unrealized loss position at December 31, 2009. Based upon our analysis of general market conditions and underlying factors impacting these debt securities, we considered these declines in value to be temporary.

We included losses of \$0, \$1.2 million and \$469,000 in net realized investment gains (losses) in 2009, 2008 and 2007, respectively, for certain equity investments trading below cost on an other-than-temporary basis.

We had no sales or transfers from the held to maturity portfolio in 2009, 2008 or 2007.

We have no derivative instruments or hedging activities.

6 — Fair Value Measurements

We account for financial assets using a framework that establishes a hierarchy that ranks the quality and reliability of inputs, or assumptions, used in the determination of fair value, and we classify financial assets and liabilities carried at fair value in one of the following three categories:

Level 1 — quoted prices in active markets for identical assets and liabilities;

Level 2 — directly or indirectly observable inputs other than Level 1 quoted prices; and

Level 3 — unobservable inputs not corroborated by market data.

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly traded equity securities as Level 1. When quoted market prices in active markets are not available, we base fair values on quoted market prices of comparable instruments or broker quotes. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury securities and obligations of U.S. government corporations and agencies, obligations of states and political subdivisions, corporate securities and residential mortgage-backed securities.

We reclassified one equity security to Level 3 during 2009. We utilized a fair value model that incorporated significant unobservable inputs, such as estimated volatility, to estimate the equity security's fair value. We are restricted from selling this equity security, which we obtained in an initial public offering, for a period of 18 to 24 months, and the fair value we determined as of December 31, 2009 reflects this selling restriction. We recorded an unrealized gain of \$3.4 million related to this security in other comprehensive income for the year ended December 31, 2009.

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security were sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for substantially all of our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. The pricing services do not use broker quotes in determining the fair values of our investments. We review the estimates of fair value provided by the pricing services to determine if the estimates obtained are representative of fair values based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. As of December 31, 2009 and 2008, we received one estimate per security from one of the pricing services, and we priced all but an insignificant amount of our Level 1 and Level 2 investments using those prices. In our review of the estimates provided by the pricing services as of December 31, 2009 and 2008, we did not identify any discrepancies, and we did not make any adjustments to the estimates the pricing services provided.

We present our cash and short-term investments at cost, which approximates fair value. The carrying values in our consolidated balance sheets for premium and reinsurance receivables and payables approximate their fair values. The carrying amounts reported in our consolidated balance sheets for our subordinated debentures approximate their fair values due to their variable rate nature.

We evaluate our assets and liabilities on a regular basis to determine the appropriate level at which to classify them for each reporting period.

The following table presents our fair value measurements for our investments in available-for-sale fixed maturities and equity securities as of December 31, 2009:

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 40,630,079	\$ —	\$ 40,630,079	\$ —
Obligations of states and political subdivisions	358,366,478	—	358,366,478	—
Corporate securities	27,765,803	—	27,765,803	—
Residential mortgage- backed securities	90,941,312	—	90,941,312	—
Equity securities	9,914,626	2,426,567	1,256,405	6,231,654
Totals	\$527,618,298	\$2,426,567	\$518,960,077	\$6,231,654

The following table presents our fair value measurements for our investments in available-for-sale fixed maturities and equity securities as of December 31, 2008:

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 6,630,300	\$ —	\$ 6,630,300	\$ —
Obligations of states and political subdivisions	337,002,833	—	337,002,833	—
Corporate securities	23,935,714	—	23,935,714	—
Residential mortgage- backed securities	78,246,902	—	78,246,902	—
Equity securities	5,894,975	4,970,501	924,474	—
Totals	\$451,710,724	\$4,970,501	\$446,740,223	\$ —

The following table presents a roll forward of the significant unobservable inputs for our Level 3 equity securities for 2009:

Balance, January 1	\$ —
Reclassification to Level 3	4,958,531
Sales of securities	(1,293,600)
Change in net unrealized gains	2,566,723
Balance, December 31	\$ 6,231,654

7 — Deferred Policy Acquisition Costs

Changes in our insurance subsidiaries' deferred policy acquisition costs are as follows:

	2009	2008	2007
Balance, January 1	\$ 29,541,281	\$ 26,235,072	\$ 24,738,929
Acquisition costs deferred	63,594,898	61,556,209	52,701,143
Amortization charged to earnings	(60,292,000)	(58,250,000)	(51,205,000)
Balance, December 31	\$ 32,844,179	\$ 29,541,281	\$ 26,235,072

8 — Property and Equipment

Property and equipment at December 31, 2009 and 2008 consisted of the following:

	2009	2008	Estimated Useful Life
Office equipment	\$ 8,177,197	\$ 7,835,404	5-15 years
Automobiles	1,591,133	1,576,055	3 years
Real estate	5,016,722	4,981,529	15-50 years
Software	1,631,763	1,077,790	5 years
	16,416,815	15,470,778	
Accumulated depreciation	(9,824,592)	(8,784,094)	
	\$ 6,592,223	\$ 6,686,684	

Depreciation expense for 2009, 2008 and 2007 amounted to \$1.0 million, \$1.0 million and \$901,798, respectively.

9 — Liability for Losses and Loss Expenses

The establishment of an appropriate liability for losses and loss expenses is an inherently uncertain process, and there can be no assurance that our insurance subsidiaries' ultimate liability will not exceed their loss and loss expense reserves and have an adverse effect on our results of operations and financial condition. Furthermore, we cannot predict the timing, frequency and extent of adjustments to our insurance subsidiaries' estimated future liabilities, since the historical conditions and events that serve as a basis for their estimates of ultimate claim costs may change. As is the case for substantially all property and casualty insurance companies, our insurance subsidiaries have found it necessary in the past to increase their estimated future liabilities for losses and loss expenses in certain periods, and in other periods our insurance subsidiaries' estimates have exceeded their actual liabilities. Changes in our insurance subsidiaries' estimate of their liability for losses and loss expenses generally reflect actual payments and their evaluation of information received since the prior reporting date.

We summarize activity in our insurance subsidiaries' liability for losses and loss expenses as follows:

	2009	2008	2007
Balance at January 1	\$239,809,276	\$226,432,402	\$259,022,459
Less reinsurance recoverable	(78,502,518)	(76,280,437)	(95,710,496)
Net balance at January 1	161,306,758	150,151,965	163,311,963
Acquisition of Sheboygan	—	2,173,374	—
Incurred related to:			
Current year	241,012,436	221,617,127	187,796,474
Prior years	9,822,960	2,683,837	(10,012,842)
Total incurred	250,835,396	224,300,964	177,783,632
Paid related to:			
Current year	152,292,967	143,369,098	118,444,254
Prior years	79,587,069	71,950,447	72,499,376
Total paid	231,880,036	215,319,545	190,943,630
Net balance at December 31	180,262,118	161,306,758	150,151,965
Plus reinsurance recoverable	83,336,726	78,502,518	76,280,437
Balance at December 31	\$263,598,844	\$239,809,276	\$226,432,402

Our insurance subsidiaries recognized an increase (decrease) in their liability for losses and loss expenses of prior years of \$9.8 million, \$2.7 million and (\$10.0) million in 2009, 2008 and 2007, respectively. Our insurance subsidiaries made no significant changes in their reserving philosophy, key reserving assumptions or claims management personnel, and have made no significant offsetting changes in estimates that increased or decreased their loss and loss expense reserves in these years. The majority of the 2009 development related to increases in the liability for losses and loss expenses of prior years for Atlantic States and Southern. The 2009 development represented 6.0% of our December 31, 2008 carried reserves and was driven primarily by higher-than-expected severity in the private passenger automobile liability, homeowners and workers' compensation lines of business in accident year 2008. The 2008 development represented 1.2% of our December 31, 2007 carried reserves and was driven primarily by higher-than-expected severity in the private passenger automobile liability line of business in accident year 2007. Our insurance subsidiaries recognized favorable development in 2007 primarily in the private passenger automobile liability, workers' compensation, commercial automobile liability and commercial multi-peril lines of business.

10 — Borrowings

Line of Credit

On November 25, 2003, we entered into a credit agreement with Manufacturers and Traders Trust Company ("M&T") relating to a four-year \$35.0 million unsecured, revolving line of credit. On July 20, 2006, we amended the agreement with M&T to extend the credit agreement for four years from the date of amendment on substantially the same terms. As of December 31, 2009, we may borrow up to \$35.0 million at interest rates equal to M&T's current prime rate or the then current London Interbank Eurodollar bank rate (LIBOR) plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount, regardless of usage. The agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and A.M. Best ratings of our insurance subsidiaries. During the year ended December 31, 2009, we had no outstanding borrowings, and we complied with all requirements of the credit agreement. We intend to extend the credit agreement during 2010.

Subordinated Debentures

On May 15, 2003, we received \$15.0 million in net proceeds from the issuance of subordinated debentures. We redeemed these debentures on August 15, 2008.

On October 29, 2003, we received \$10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par. The debentures carry an interest rate equal to the three-month LIBOR rate plus 4.10%, which is adjustable quarterly. At December 31, 2009, the interest rate on these debentures was 4.37% and was next subject to adjustment on February 15, 2010. As of December 31, 2009 and 2008, our consolidated balance sheets included an investment in a statutory trust of \$310,000 and subordinated debentures of \$10.3 million related to this transaction.

On May 24, 2004, we received \$5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At December 31, 2009, the interest rate on these debentures was 4.11% and was next subject to adjustment on February 24, 2010. As of December 31, 2009 and 2008, our consolidated balance sheets included an investment in a statutory trust of \$155,000 and subordinated debentures of \$5.2 million related to this transaction.

11 — Reinsurance

Unaffiliated Reinsurers

Our insurance subsidiaries and Donegal Mutual purchase certain third-party reinsurance on a combined basis. Le Mars, Peninsula and Sheboygan also have separate third-party reinsurance programs that provide certain coverage that is commensurate with their relative size and exposures. Our insurance subsidiaries use several different reinsurers, all of which, consistent with the requirements of our insurance subsidiaries and Donegal Mutual, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating from A.M. Best. The external reinsurance our insurance subsidiaries and Donegal Mutual purchase includes "excess of loss reinsurance," under which their losses are automatically reinsured, through a series of contracts, over a set retention (generally \$750,000), and "catastrophic reinsurance," under which they recover, through a series of contracts, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (generally \$3.0 million). Our insurance subsidiaries' principal third party reinsurance agreement in 2009 was a multi-line per risk excess of loss treaty that provided 100% coverage up to \$1.0 million for both property and liability losses over the set retention. For property insurance, our insurance subsidiaries also had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$2.5 million per loss. For liability insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$40.0 million per occurrence. For workers' compensation insurance, our insurance subsidiaries had excess of loss treaties that provided for additional coverage over the multi-line treaty up to \$10.0 million on any one life. Our insurance subsidiaries and Donegal Mutual had property catastrophe coverage through a series of layered treaties up to aggregate losses of \$100.0 million for any single event. As many as nine reinsurers provided coverage on any one treaty with no reinsurer taking more than 29.0% of any one contract. The amount of coverage provided under each of these types of reinsurance depends upon the amount, nature, size and location of the risks being reinsured. Donegal Mutual and our insurance subsidiaries also purchased facultative reinsurance to cover exposures from losses that exceeded the limits provided by our respective treaty reinsurance. The following amounts represent ceded reinsurance transactions with unaffiliated reinsurers during 2009, 2008 and 2007:

	2009	2008	2007
Premiums written	\$19,758,224	\$19,458,572	\$22,922,229
Premiums earned	\$19,870,265	\$19,348,674	\$22,805,393
Losses and loss expenses	\$ 6,796,388	\$11,129,036	\$ 4,934,928
Prepaid reinsurance premiums	\$ 1,985,821	\$ 2,097,870	\$ 1,949,428
Liability for losses and loss expenses	\$22,692,993	\$27,258,815	\$26,046,365

Total Reinsurance

The following amounts represent our total ceded reinsurance transactions with both affiliated and unaffiliated reinsurers during 2009, 2008 and 2007:

	2009	2008	2007
Premiums earned	\$127,203,132	\$119,073,801	\$114,829,037

Losses and loss expenses	\$ 87,129,668	\$ 74,112,920	\$ 47,174,704
Prepaid reinsurance premiums	\$ 56,040,728	\$ 51,436,487	\$ 47,286,334
Liability for losses and loss expenses	\$ 83,336,726	\$ 78,502,518	\$ 76,280,437

The following amounts represent the effect of reinsurance on premiums written for 2009, 2008 and 2007:

	2009	2008	2007
Direct	\$ 250,989,795	\$ 241,371,353	\$ 229,328,954
Assumed	244,046,312	246,755,110	202,099,203
Ceded	(131,807,381)	(123,185,408)	(117,738,418)
Net premiums written	\$ 363,228,726	\$ 364,941,055	\$ 313,689,739

The following amounts represent the effect of reinsurance on premiums earned for 2009, 2008 and 2007:

	2009	2008	2007
Direct	\$ 246,074,766	\$ 235,212,229	\$ 225,684,220
Assumed	236,153,843	230,436,838	199,216,351
Ceded	(127,203,132)	(119,073,801)	(114,829,037)
Net premiums earned	\$ 355,025,477	\$ 346,575,266	\$ 310,071,534

12 — Income Taxes

Our provision for income tax consists of the following:

	2009	2008	2007
Current	\$ 3,096,798	\$ 7,382,694	\$ 13,539,991
Deferred	(1,250,187)	(832,628)	1,029,042
Federal tax provision	\$ 1,846,611	\$ 6,550,066	\$ 14,569,033

Our effective tax rate is different from the amount computed at the statutory federal rate of 35% for 2009, 2008 and 2007. The reasons for such difference and the related tax effects are as follows:

	2009	2008	2007
Income before income taxes	\$20,676,689	\$32,092,044	\$52,848,938
Computed "expected" taxes	7,236,841	11,232,215	18,497,128
Tax-exempt interest	(6,237,961)	(5,668,566)	(4,548,711)
Dividends received deduction	(17,574)	(62,470)	(125,977)
Other, net	865,305	1,048,887	746,593
Federal income tax provision	\$ 1,846,611	\$ 6,550,066	\$ 14,569,033

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2009 and 2008 are as follows:

	2009	2008
Deferred tax assets:		
Unearned premium	\$13,043,976	\$12,506,590
Loss reserves	5,715,157	5,309,536
Net operating loss carryforward — acquired companies	2,497,122	2,628,568
Other	4,000,325	3,510,896
Total gross deferred assets	25,256,580	23,955,590
Less valuation allowance	(746,368)	(746,368)
Net deferred tax assets	24,510,212	23,209,222
Deferred tax liabilities:		
Depreciation expense	597,036	570,539
Deferred policy acquisition costs	11,505,045	10,531,684
Salvage recoverable	200,789	189,521
Net unrealized gains	7,120,393	922,834
Total gross deferred liabilities	19,423,263	12,214,578
Net deferred tax asset	\$ 5,086,949	\$ 10,994,644

We provide a valuation allowance when we believe it is more likely than not that we will not realize some portion of the tax asset. We established a valuation allowance of \$746,368 related to a portion of the net operating loss carryforward of Le Mars at January 1, 2004. We have determined that we are not required to establish a valuation allowance for the other net deferred tax assets of \$24.5 million and \$23.2 million at December 31, 2009 and 2008, respectively, since it is more likely than not that we will realize these deferred tax assets through reversals of existing temporary differences, future taxable income, carrybacks to taxable income in prior years and the implementation of tax planning strategies.

At December 31, 2009, we have a net operating loss carryforward of \$7.2 million, which is available to offset our taxable income. This amount will begin to expire in 2011 if not utilized and is subject to an annual limitation in the amount that we can use in any one year of approximately \$376,000. We also have an alternative minimum tax credit carryforward of \$412,374 with an indefinite life.

13 — Stockholders' Equity

On April 19, 2001, our stockholders approved an amendment to our certificate of incorporation. Among other things, the amendment reclassified our common stock as Class B common stock and effected a one-for-three reverse split of our Class B common stock effective April 19, 2001. The amendment also authorized a new class of common stock with one-tenth of a vote per share designated as Class A common stock. Our board of directors also declared a dividend of two shares of Class A common stock for each share of Class B common stock, after the one-for-three reverse split, held of record at the close of business on April 19, 2001.

Each share of Class A common stock outstanding at the time of the declaration of any dividend or other distribution payable in cash upon the shares of Class B common stock is entitled to a dividend or distribution payable at the same time and to stockholders of record on the same date in an amount at least 10% greater than any dividend declared upon each share of Class B common stock. In the event of our merger or

consolidation with or into another entity, the holders of Class A common stock and the holders of Class B common stock are entitled to receive the same per share consideration in such merger or consolidation. In the event of our liquidation, dissolution or winding-up, any assets available to common stockholders will be distributed pro-rata to the holders of Class A common stock and Class B common stock after payment of all our obligations.

In March 2007, our board of directors authorized a share repurchase program, pursuant to which we purchased 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of Securities and Exchange Commission (SEC) Rule 10b-18 and in privately negotiated transactions. We purchased 19,231 and 214,343 shares of our Class A common stock under this program during 2009 and 2008, respectively. As of December 31, 2009, we had no remaining authorization to purchase shares under this program.

In February 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We purchased 7,669 shares of our Class A common stock under this program during 2009. As of December 31, 2009, we had the authority to purchase 292,331 shares under this program.

As of December 31, 2009, our treasury stock consisted of 652,599 and 72,465 shares of Class A common stock and Class B common stock, respectively. As of December 31, 2008, our treasury stock consisted of 625,699 and 72,465 shares of Class A common stock and Class B common stock, respectively.

14 — Stock Compensation Plans

Equity Incentive Plans

During 1996, we adopted an Equity Incentive Plan for Employees. During 2001, we adopted a nearly identical plan that made a total of 2,666,667 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. During 2005, we amended the plan to make a total of 4,000,000 shares of Class A common stock available for issuance. During 2007, we adopted a nearly identical plan that made a total of 3,500,000 shares of Class A common stock available for issuance to employees of our subsidiaries and affiliates. Each plan provides for the granting of awards by our board of directors in the form of stock options, stock appreciation rights, restricted stock or any combination of the above. The plans provide that stock options may become exercisable up to ten years from date of grant with an option price not less than fair market value on date of grant. We have not granted any stock appreciation rights.

During 1996, we adopted an Equity Incentive Plan for Directors. During 2001, we adopted a nearly identical plan that made 355,556 shares of Class A common stock available for issuance to our directors and those of our subsidiaries and affiliates. During 2007, we adopted a nearly identical plan that made 400,000 shares of Class A common stock available for issuance to our directors and the directors of our subsidiaries and affiliates. We may make awards in the form of stock options. The plan also provides for the issuance of 311 shares of restricted stock to each director on the first business day of January in each year. As of December 31, 2009, we had 302,499 unexercised options under these plans. In addition, we issued 4,665, 4,665 and 4,976 shares of restricted stock on January 2, 2009, 2008 and 2007, respectively.

We measure all share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in our results of operations. In determining the expense we record for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, we estimate the fair value of each option award on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilize in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility. The risk-free interest rate is the implied yield currently available on U.S. Treasury zero coupon issues with a remaining term equal to the expected term used as the assumption in the model. The expected term of an option award is based on historical experience of similar awards. The dividend yield is determined by dividing the per share dividend by the grant date stock price. The expected volatility is based on the volatility of our stock price over a historical period comparable to the expected term.

The weighted-average grant date fair value of options granted during 2009 was \$1.63. We calculated this fair value based upon a risk-free interest rate of 1.50%, expected life of 3 years, expected volatility of 24% and expected dividend yield of 3%.

The weighted-average grant date fair value of options granted during 2008 was \$2.06. We calculated this fair value based upon a risk-free interest rate of 2%, expected life of 3 years, expected volatility of 21% and expected dividend yield of 2%.

The weighted-average grant date fair value of options granted during 2007 was \$1.15. We calculated this fair value based upon a risk-free interest rate of 3%, expected life of 3 years, expected volatility of 20% and expected dividend yield of 2%.

We charged compensation expense for our stock compensation plans against income before income taxes of \$232,872, \$205,288 and \$343,442 for the years ended December 31, 2009, 2008 and 2007, respectively, with a corresponding income tax benefit of \$79,176, \$71,851 and \$120,205. As of December 31, 2009 and 2008, our total unrecognized compensation cost related to nonvested share-based compensation granted under the plan was \$91,026 and \$257,610, respectively. We expect to recognize this cost over a weighted average period of 2.6 years.

We account for share-based compensation to employees and directors of Donegal Mutual as share-based compensation to employees of a controlling entity. As such, we measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options granted to the employees and directors of Donegal Mutual, the employer of record for the employees that provide services to us. We recorded implied dividends of \$62,991, \$1,749,063 and \$65,179 for the years ended December 31, 2009, 2008 and 2007, respectively.

Cash received from option exercises under all stock compensation plans for the years ended December 31, 2009, 2008 and 2007 was \$0, \$2,358,916 and \$1,768,799, respectively. The actual tax benefit realized for the tax deductions from option exercises of share-based compensation was \$0, \$683,881 and \$854,945 for the years ended December 31, 2009, 2008 and 2007, respectively.

All options issued prior to 2001 converted to options on Class A and Class B common stock as a result of our recapitalization. No further shares are available for plans in effect prior to 2008.

Information regarding activity in our stock option plans follows:

	Number of Options	Weighted-Average Exercise Price Per Share
Outstanding at December 31, 2006	2,683,827	\$16.44
Granted — 2007	20,500	21.00
Exercised — 2007	(246,327)	7.18
Forfeited — 2007	(73,278)	19.17
Outstanding at December 31, 2007	2,384,722	17.36
Granted — 2008	1,368,500	17.52
Exercised — 2008	(247,955)	9.51
Forfeited — 2008	(82,835)	17.80
Outstanding at December 31, 2008	3,422,432	17.98
Granted — 2009	5,000	17.50
Forfeited — 2009	(137,333)	17.97
Outstanding at December 31, 2009	3,290,099	\$17.98
Exercisable at:		
December 31, 2007	1,303,097	\$15.90
December 31, 2008	1,767,810	\$17.74
December 31, 2009	2,451,556	\$18.13

Shares available for future option grants at December 31, 2009 total 2,622,670 shares under all plans.

The following table summarizes information about outstanding stock options at December 31, 2009:

Number of	Weighted-Average	Number of
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Exercise Price	Options Outstanding	Remaining Contractual Life	Options Exercisable
\$15.75	1,059,432	0.5 years	1,059,432
17.50	1,244,500	3.5 years	414,792
17.65	4,000	0.5 years	4,000
18.70	3,000	3.5 years	1,000
21.00	958,667	2.0 years	958,667
21.00	20,500	3.0 years	13,665
Total	3,290,099		2,451,556

Employee Stock Purchase Plans

During 1996, we adopted an Employee Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance.

The 2001 plan extends over a ten-year period and provides for shares to be offered to all eligible employees at a purchase price equal to the lesser of 85% of the fair market value of our Class A common stock on the last day before the first day of each enrollment period (June 1 and December 1 of each year) under the plan or 85% of the fair market value of our

common stock on the last day of each subscription period (June 30 and December 31 of each year). A summary of plan activity follows:

	Shares Issued	
	Price	Shares
January 1, 2007	\$15.02	10,929
July 1, 2007	12.67	13,264
January 1, 2008	12.98	14,593
July 1, 2008	13.49	11,498
January 1, 2009	14.25	10,770
July 1, 2009	12.93	11,304

On January 1, 2010, we issued an additional 11,717 shares at a price of \$12.85 per share under this plan.

Agency Stock Purchase Plans

During 1996, we adopted an Agency Stock Purchase Plan. During 2001, we adopted a nearly identical plan that made 533,333 shares of Class A common stock available for issuance. The plan provides for agents of our insurance subsidiaries and Donegal Mutual to invest up to \$12,000 per subscription period (April 1 to September 30 and October 1 to March 31 of each year) under various methods. We issue stock at the end of each subscription period at a price equal to 90% of the average market price during the last ten trading days of each subscription period. During 2009, 2008 and 2007, we issued 48,427, 48,054 and 58,255 shares, respectively, under this plan. Expense recognized under the plan was not material.

15 — Statutory Net Income, Capital and Surplus and Dividend Restrictions

The following is selected information, as filed with insurance regulatory authorities, for our insurance subsidiaries as determined in accordance with accounting practices prescribed or permitted by such insurance regulatory authorities:

	2009	2008	2007
Atlantic States			
Statutory capital and surplus	\$189,679,919	\$182,403,593	\$180,739,409
Statutory unassigned surplus	\$133,732,099	\$128,742,729	\$127,078,545
Statutory net income	\$ 12,445,231	\$ 18,412,955	\$ 24,052,423
Southern			
Statutory capital and surplus	\$ 64,519,825	\$ 64,272,437	\$ 64,507,274
Statutory unassigned surplus	\$ 15,402,239	\$ 15,154,851	\$ 15,389,688
Statutory net (loss) income	\$ (1,017,998)	\$ 1,608,947	\$ 5,046,129
Le Mars			
Statutory capital and surplus	\$ 28,288,730	\$ 27,914,815	\$ 28,311,698
Statutory unassigned surplus	\$ 15,277,563	\$ 15,322,075	\$ 15,718,958
Statutory net income	\$ 716,138	\$ 1,886,785	\$ 5,127,324
Peninsula			
Statutory capital and surplus	\$ 38,986,329	\$ 39,137,131	\$ 36,904,467
Statutory unassigned surplus	\$ 20,832,470	\$ 21,337,717	\$ 19,105,053
Statutory net income	\$ 1,023,349	\$ 4,082,064	\$ 5,037,902
Sheboygan			
Statutory capital and surplus	\$ 11,857,971	\$ 11,176,704	\$ 10,644,246
Statutory unassigned (deficit) surplus	\$ (243,626)	\$ (855,467)	\$ 7,144,246
Statutory net income (loss)	\$ 588,098	\$ (1,110,861)	\$ 632,202

Our principal source of cash for payment of dividends is dividends from our insurance subsidiaries. State insurance laws require our insurance subsidiaries to maintain certain minimum capital and surplus on a statutory basis. Our insurance subsidiaries are subject to regulations that restrict payment of dividends from statutory surplus and may require prior approval of their domiciliary insurance regulatory authorities. Our insurance subsidiaries are also subject to risk-based capital (RBC) requirements that may further impact their ability to pay dividends. At December 31, 2009, our insurance subsidiaries had statutory capital and surplus substantially above their respective RBC requirements. Amounts available for distribution to us as dividends from our insurance subsidiaries without prior approval of insurance regulatory authorities in 2010 are \$12,445,231 from Atlantic States, \$0 from Southern, \$2,828,873 from Le Mars, \$3,898,633 from Peninsula and \$584,431 from Sheboygan.

16 — Reconciliation of Statutory Filings to Amounts Reported Herein

Our insurance subsidiaries must file financial statements with state insurance regulatory authorities using accounting principles and practices established by those authorities, which we refer to as statutory accounting principles (SAP). 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 SAP, to the amounts included in the accompanying financial statements are as follows:

	Year Ended December 31,		
	2009	2008	2007
Statutory net income of insurance subsidiaries	\$ 13,754,818	\$ 25,946,589	\$ 39,263,778
Increases (decreases):			
Deferred policy acquisition costs	3,302,898	3,306,209	1,496,143

Deferred federal income taxes	1,250,187	811,722	(1,029,042)
Salvage and subrogation recoverable	542,000	270,000	131,000
Consolidating eliminations and adjustments	(13,521,106)	(23,708,578)	(17,731,328)
Parent-only net income	13,501,281	18,916,036	16,149,354
Net income as reported herein	\$ 18,830,078	\$ 25,541,978	\$ 38,279,905

	December 31,		
	2009	2008	2007
Statutory capital and surplus of insurance subsidiaries	\$333,332,774	\$324,904,680	\$310,462,848
Increases (decreases):			
Deferred policy acquisition costs	32,844,179	29,541,281	26,235,072
Deferred federal income taxes	(15,676,995)	(5,914,123)	(7,918,623)
Salvage and subrogation recoverable	9,207,000	8,665,000	8,275,000
Non-admitted assets and other adjustments, net	2,913,878	2,795,785	1,906,929
Fixed maturities	13,135,848	(3,419,625)	4,637,841
Parent-only equity and other adjustments	9,749,015	7,010,867	9,091,124
Stockholders' equity as reported herein	\$385,505,699	\$363,583,865	\$352,690,191

17 — Supplementary Cash Flow Information

The following table reflects income taxes and interest paid during 2009, 2008 and 2007:

	2009	2008	2007
Income taxes	\$1,307,418	\$9,325,000	\$11,300,000
Interest	\$1,828,278	\$2,040,017	\$ 2,905,512

During 2009, we paid interest and penalties in the amount of \$974,204 related to a premium tax litigation settlement. We recorded this amount as interest expense in accordance with our accounting policy.

18 — Earnings Per Share

We have two classes of common stock, which we refer to as Class A common stock and Class B common stock. Our Class A common stock is entitled to cash dividends that are at least 10% higher than the cash dividends declared and paid on our Class B common stock. Accordingly, we use the two-class method for the computation of earnings per common share. The two-class method is an earnings allocation formula that determines earnings per share separately for each class of common stock based on dividends declared and an allocation of remaining undistributed earnings using a participation percentage reflecting the dividend rights of each class.

We present below a reconciliation of the numerators and denominators we used in the basic and diluted per share computations for our Class A common stock:

Year Ended December 31,	(dollars in thousands, except per share data)		
	2009	2008	2007
Basic earnings per share:			
Numerator:			
Allocation of net income	\$ 15,049	\$ 20,404	\$ 30,514
Denominator:			
Weighted-average shares outstanding	19,903,069	19,866,099	19,685,674
Basic earnings per share	\$ 0.76	\$ 1.03	\$ 1.55
Diluted earnings per share:			
Numerator:			
Allocation of net income	\$ 15,049	\$ 20,404	\$ 30,514
Denominator:			
Number of shares used in basic computation	19,903,069	19,866,099	19,685,674
Weighted-average effect of dilutive securities			
Add: Director and employee stock options	—	89,419	277,184
Number of shares used in per share computations	19,903,069	19,955,518	19,962,858
Diluted earnings per share	\$ 0.76	\$ 1.02	\$ 1.53

We used the following information in the basic and diluted per share computations for our Class B common stock:

Year Ended December 31,	(dollars in thousands, except per share data)		
	2009	2008	2007
Basic and diluted earnings per share:			
Numerator:			
Allocation of net income	\$ 3,781	\$ 5,138	\$ 7,766
Denominator:			
Weighted-average shares outstanding	5,576,775	5,576,775	5,576,775
Basic and diluted earnings per share	\$ 0.68	\$ 0.92	\$ 1.39

During 2009, 2008 and 2007, we did not include certain options to purchase shares of common stock in the computation of diluted earnings per share because the exercise price of the options was greater than the average market price. The following reflects such options that remained outstanding at December 31, 2009, 2008 and 2007:

	2009	2008	2007
Options excluded from diluted earnings per share	3,290,099	1,018,167	1,028,667

19 — Condensed Financial Information of Parent Company

Condensed Balance Sheets

(in thousands)

December 31,	2009	2008
Assets		
Fixed-maturity investments	\$ —	\$ —
Investment in subsidiaries/affiliates (equity method)	385,445	366,252
Short-term investments	15,445	12,836
Cash	1,105	1,612
Property and equipment	1,262	1,067
Other	875	594
Total assets	\$404,132	\$382,361

Liabilities and Stockholders' Equity

Liabilities		
Cash dividends declared to stockholders	\$ 2,798	\$ 2,602
Subordinated debentures	15,465	15,465
Other	364	710

Total liabilities	18,627	18,777
Stockholders' equity	385,505	363,584
Total liabilities and stockholders' equity	\$404,132	\$382,361

Condensed Statements of Income and Comprehensive Income

(in thousands)

Year Ended December 31,	2009	2008	2007
Statements of Income			
Revenues			
Dividends from subsidiaries	\$14,000	\$20,000	\$18,000
Other	1,005	1,785	1,950
Total revenues	15,005	21,785	19,950
Expenses			
Operating expenses	1,019	1,558	1,896
Interest	773	1,822	2,886
Total expenses	1,792	3,380	4,782
Income before income tax benefit and equity in undistributed net income of subsidiaries	13,213	18,405	15,168
Income tax benefit	(288)	(511)	(981)
Income before equity in undistributed net income of subsidiaries	13,501	18,916	16,149
Equity in undistributed net income of subsidiaries	5,329	6,626	22,131
Net income	\$18,830	\$25,542	\$38,280
Statements of Comprehensive Income			
Net income	\$18,830	\$25,542	\$38,280
Other comprehensive (loss) income, net of tax			
Unrealized (loss) gain — parent	—	(60)	102
Unrealized gain (loss) — subsidiaries	13,293	(5,201)	1,811
Other comprehensive income (loss), net of tax	13,293	(5,261)	1,913
Comprehensive income	\$32,123	\$20,281	\$40,193

Condensed Statements of Cash Flows

(in thousands)

Year Ended December 31,	2009	2008	2007
Cash flows from operating activities:			
Net income	\$ 18,830	\$ 25,542	\$ 38,280
Adjustments:			
Equity in undistributed net income of subsidiaries	(5,329)	(6,626)	(22,131)
Other	(669)	924	254
Net adjustments	(5,998)	(5,702)	(21,877)
Net cash provided	12,832	19,840	16,403
Cash flows from investing activities:			
Net sale of fixed maturities	—	5,214	2,000
Net (purchase) sale of short-term investments	(2,609)	11,367	(9,174)
Net purchase of property and equipment	(644)	(408)	(428)
Investment in subsidiaries	(100)	(11,568)	(50)
Other	19	110	189
Net cash (used) provided	(3,334)	4,715	(7,463)
Cash flows from financing activities:			
Cash dividends paid	(10,998)	(10,026)	(8,627)
Issuance of common stock	1,386	3,857	3,543
Tax benefit on exercise of stock options	—	684	855
Redemption of subordinated debentures	—	(15,464)	—
Repurchase of treasury stock	(393)	(3,511)	(4,308)
Net cash used	(10,005)	(24,460)	(8,537)
Net change in cash	(507)	95	403
Cash at beginning of year	1,612	1,517	1,114
Cash at end of year	\$ 1,105	\$ 1,612	\$ 1,517

20 — Segment Information

We have three reportable segments, which consist of our investment function, our personal lines of insurance and our commercial lines of insurance. Using independent agents, our insurance subsidiaries market personal lines of insurance to individuals and commercial lines of insurance to small and medium-sized businesses.

We evaluate the performance of our personal lines and commercial lines primarily based upon our insurance subsidiaries' underwriting results as determined under SAP for our total business.

We do not allocate assets to our personal and commercial lines and review them in total for purposes of decision-making. We operate only in the United States and no single customer or agent provides 10 percent or more of our revenues.

Financial data by segment is as follows:

	2009	2008	2007
	(in thousands)		
Revenues			
Premiums earned:			
Commercial lines	\$113,233	\$121,567	\$113,642
Personal lines	242,313	225,143	196,429
SAP premiums earned	355,546	346,710	310,071
GAAP adjustments	(521)	(135)	—
GAAP premiums earned	355,025	346,575	310,071
Net investment income	20,631	22,756	22,785
Realized investment gains (losses)	4,480	(2,971)	2,051
Other	6,597	6,064	5,711
Total revenues	\$386,733	\$372,424	\$340,618
Income before income tax expense:			
Underwriting income (loss):			
Commercial lines	\$ 5,805	\$ 13,819	\$ 22,744
Personal lines	(17,235)	(7,609)	1,736
SAP underwriting (loss) income	(11,430)	6,210	24,480
GAAP adjustments	3,636	3,530	2,603
GAAP underwriting (loss) income	(7,794)	9,740	27,083
Net investment income	20,631	22,756	22,785
Realized investment gains (losses)	4,480	(2,971)	2,051
Other	3,360	2,567	930
Income before income tax expense	\$ 20,677	\$ 32,092	\$ 52,849

21 — Guaranty Fund and Other Insurance-Related Assessments

Our insurance subsidiaries' liabilities for guaranty fund and other insurance-related assessments were \$2,663,049 and \$2,603,899 at December 31, 2009 and 2008, respectively. These liabilities included \$517,610 and \$307,456 related to surcharges collected by our insurance subsidiaries on behalf of regulatory authorities for 2009 and 2008, respectively.

22 — Interim Financial Data (unaudited)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$88,349,543	\$87,540,345	\$87,997,723	\$ 91,137,866
Total revenues	95,501,614	94,823,420	94,882,167	101,526,206
Net losses and loss expenses	65,949,165	61,903,131	58,609,247	64,373,853
Net income	169,804	4,387,624	6,744,851	7,527,799
Net earnings per common share:				
Class A common stock — basic	0.01	0.18	0.27	0.30
Class A common stock — diluted	0.01	0.18	0.27	0.30
Class B common stock — basic and diluted	0.01	0.16	0.24	0.27

	2008			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net premiums earned	\$82,007,766	\$87,329,195	\$88,170,757	\$89,067,548
Total revenues	89,773,677	94,026,701	92,733,420	95,890,429
Net losses and loss expenses	53,785,061	56,364,145	54,700,316	59,451,442
Net income	6,559,083	6,318,177	6,270,421	6,394,297
Net earnings per common share:				
Class A common stock — basic	0.26	0.25	0.25	0.26
Class A common stock — diluted	0.26	0.25	0.25	0.26
Class B common stock — basic and diluted	0.24	0.23	0.23	0.23

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited the accompanying consolidated balance sheets of Donegal Group Inc. and subsidiaries (Company) as of December 31, 2009 and 2008, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Donegal Group Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Donegal Group Inc.'s internal control over financial reporting as of December 31, 2009 based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 11, 2010 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

KPMG LLP

Philadelphia, Pennsylvania
March 11, 2010

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

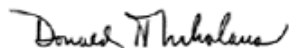
Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as that term is defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, our management has conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2009, based on the framework and criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO Framework").

Based on our evaluation under the COSO Framework, our management has concluded that our internal control over financial reporting was effective as of December 31, 2009.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

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

The effectiveness of our internal control over financial reporting has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included herein.



Donald H. Nikolaus
President and Chief Executive Officer



Jeffrey D. Miller
Senior Vice President and Chief Financial Officer

March 11, 2010

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors of Donegal Group Inc.

We have audited Donegal Group Inc.'s (Company) internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Donegal Group Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, Donegal Group Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2009, and our report dated March 11, 2010 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

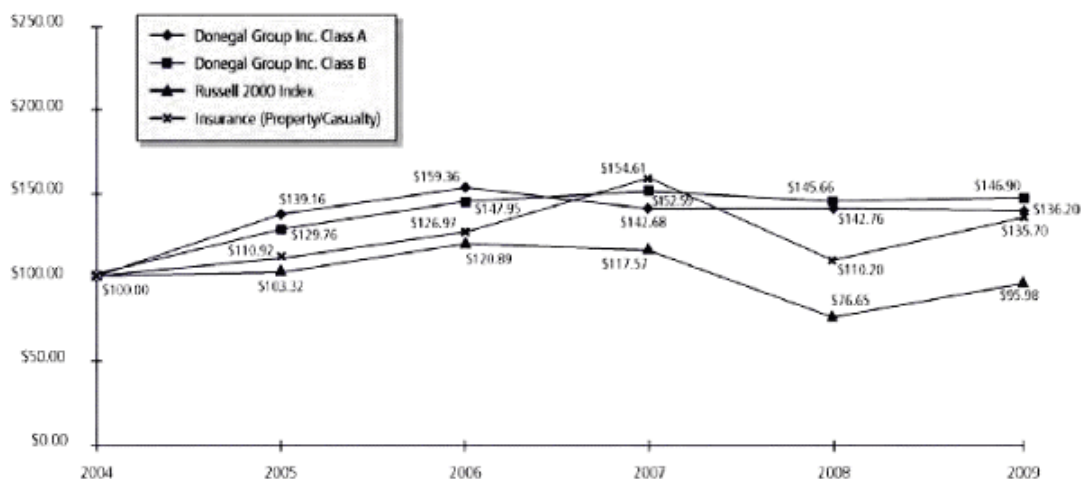
Philadelphia, Pennsylvania
March 11, 2010

COMPARISON OF TOTAL RETURN ON OUR COMMON STOCK WITH CERTAIN AVERAGES

The following graph provides an indicator of cumulative total stockholder returns on our common stock compared to the Russell 2000 Index and a peer group of property and casualty insurance companies selected by Value Line, Inc. The members of the peer group are as follows: 21st Century Holding Co., Acceptance Insurance Cos. Inc., ACE Ltd., ACMAT Corp., Affirmative Insurance Holdings Inc., Allied World Assurance Co. Holdings Ltd., Allstate Corp., American Financial Group Inc., American Physicians Capital Inc., American Safety Insurance Holdings Ltd., AMERISAFE Inc., AmTrust Financial Services Inc., Anthony Clark International Insurance Brokers Ltd., Arch Capital Group Ltd., Argo Group International Holdings Ltd., Aspen Insurance Holdings Ltd., AssuranceAmerica Corp., Assurant Inc., AXIS Capital Holdings Ltd., Baldwin & Lyons Inc. (CI A), Baldwin & Lyons Inc. (CI B), Chubb Corp., Cincinnati Financial Corp., CNA Financial Corp., CNA Surety Corp., Cninsure Inc., Conseco Inc., CRM Holdings Ltd., Donegal Group Inc. (CI A), Donegal Group Inc. (CI B), Eastern Insurance Holdings Inc., eHealth Inc., EMC Insurance Group Inc., Employers Holdings Inc., Endurance Specialty Holdings Ltd., Erie Indemnity Co. (CI A), Fairfax Financial Holdings Ltd., Fidelity National Financial Inc., First Mercury Financial Corp., Flagstone Reinsurance Holdings Ltd., Fremont Michigan InsuraCorp Inc., GAINSCO Inc., Hallmark Financial Services Inc., Harleysville Group Inc., HCC Insurance Holdings Inc., Homeowners Choice Inc., Industrial Alliance Insurance & Financial Services Inc., Infinity Property & Casualty Corp., Kingsway Financial Services Inc., Maiden Holdings Ltd., Manifold Capital Corp., Markel Corp., Meadowbrook Insurance Group Inc., Mercer Insurance Group Inc., Mercury General Corp., Montpelier Re Holdings Ltd., National Interstate Corp., Old Republic International Corp., OneBeacon Insurance Group Ltd. (CI A), Penn Millers Holding Corp., Platinum Underwriters Holdings Ltd., PMA Capital Corp. (CI A), PMI Group Inc., Progressive Corp., RLI Corp., Safety Insurance Group Inc., SeaBright Insurance Holdings Inc., Selective Insurance Group Inc., Specialty Underwriters Alli Com, State Auto Financial Corp., Sun Life Financial Inc., The Hanover Insurance Group Inc., Tower Group Inc., Travelers Cos. Inc., United America Indemnity Ltd., United Fire & Casualty Co., United Insurance Holdings Corp., Universal Insurance Holdings Inc., Validus Holdings Ltd., W.R. Berkley Corp., XL Capital Ltd. (CI A) and Zenith National Insurance Corp.

Comparison of Five-Year Cumulative Total Return*

Donegal Group Inc. Class A, Donegal Group Inc. Class B, Russell 2000 Index and Value Line Insurance (Property/Casualty)



Assumes \$100 invested at the close of trading on December 31, 2004 in Donegal Group Inc. Class A common stock, Donegal Group Inc. Class B common stock, Russell 2000 Index and Value Line Insurance (Property/Casualty).

	2004	2005	2006	2007	2008	2009
Donegal Group Inc. Class A	\$100.00	\$139.16	\$159.36	\$142.68	\$142.76	\$136.20
Donegal Group Inc. Class B	100.00	129.76	147.95	152.59	145.66	146.90
Russell 2000 Index	100.00	103.32	120.89	117.57	76.65	95.98
Insurance (Property/Casualty)	100.00	110.92	126.97	154.61	110.20	135.70

* Cumulative total return assumes reinvestment of dividends.

CORPORATE INFORMATION

Annual Meeting

April 15, 2010 at the Company's headquarters at 10:00 a.m.

Form 10-K

A copy of Donegal Group's Annual Report on Form 10-K will be furnished free upon written request to Jeffrey D. Miller, Senior Vice President and Chief Financial Officer, at the corporate address.

Market Information

Donegal Group's Class A common stock and Class B common stock trade on the NASDAQ Global Select Market under the symbols "DGICA" and "DGICB." The following table shows the dividends paid per share and the stock price range for both classes of stock for each quarter during 2009 and 2008:

Quarter	High	Low	Cash Dividend Declared Per Share
2008 — Class A			
1st	\$18.00	\$15.60	\$ —
2nd	17.95	15.51	.105
3rd	23.00	15.31	.105
4th	18.00	11.24	.21
2008 — Class B			
1st	\$19.98	\$17.67	\$ —
2nd	19.01	17.00	.0925
3rd	18.93	17.00	.0925
4th	18.76	11.04	.185
2009 — Class A			
1st	\$17.00	\$12.25	\$ —
2nd	17.47	13.61	.1125
3rd	16.60	14.31	.1125
4th	16.02	14.22	.225
2009 — Class B			
1st	\$17.50	\$13.06	\$ —
2nd	16.68	13.41	.10
3rd	17.68	12.75	.10
4th	22.00	15.43	.20

Corporate Offices

1195 River Road
P.O. Box 302
Marietta, Pennsylvania 17547-0302
(800) 877-0600
E-mail Address: info@donegalgroup.com
Donegal Web Site: www.donegalgroup.com

Transfer Agent

Computershare Trust Company, N.A.
P.O. Box 43078
Providence, Rhode Island 02940-3078
(800) 317-4445
Web Site: www.computershare.com
Hearing Impaired: TDD: 800-952-9245

Dividend Reinvestment and Stock Purchase Plan

The Company offers a dividend reinvestment and stock purchase plan through its transfer agent. For information contact: Donegal Group Inc. Dividend Reinvestment and Stock Purchase Plan Computershare Trust Company, N.A. P.O. Box 43078 Providence, Rhode Island 02940-3078

Stockholders

The following represent the number of common stockholders of record as of December 31, 2009:

Class A common stock	1,220
Class B common stock	421

SUBSIDIARIES OF REGISTRANT

Registrant owns 100% of the outstanding stock of the following companies, except as noted:

Name	State of Formation
Atlantic States Insurance Company	Pennsylvania
Southern Insurance Company of Virginia	Virginia
Le Mars Insurance Company	Iowa
The Peninsula Insurance Company	Maryland
Peninsula Indemnity Company*	Maryland
Donegal Financial Services Corporation**	Delaware
Province BankFSB***	U.S.
Sheboygan Falls Insurance Company	Wisconsin

* Wholly owned by The Peninsula Insurance Company.

** Registrant owns 48.2%. Donegal Mutual Insurance Company owns 51.8%.

*** Wholly owned by Donegal Financial Services Corporation.

REPORT AND CONSENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors
Donegal Group Inc.:

The audits referred to in our audit report dated March 11, 2010 with respect to the consolidated financial statements of Donegal Group Inc. and subsidiaries (Company) included the related financial statement schedule as of December 31, 2009 and 2008, and for each of the years in the three-year period ended December 31, 2009, included in the annual report on Form 10-K. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits. In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We consent to the incorporation by reference in the registration statements (Nos. 333-93785, 333-94301, 333-89644, 333-62970, 333-62974, 333-62976 and 333-142614) on Form S-8 and registration statements (Nos. 333-59828 and 333-63102) on Form S-3 of Donegal Group Inc. of our reports dated March 11, 2010, with respect to the consolidated balance sheets of Donegal Group Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income and comprehensive income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2009, and the related financial statement schedule and the effectiveness of internal control over financial reporting as of December 31, 2009, which reports are incorporated by reference or appear in the December 31, 2009 annual report on Form 10-K of Donegal Group Inc.

/s/ KPMG LLP

Philadelphia, Pennsylvania

March 11, 2010

CERTIFICATION

I, Donald H. Nikolaus, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2009 of Donegal Group Inc.;

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

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

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

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

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

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

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

or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

/s/ Donald H. Nikolaus

Donald H. Nikolaus, President

Date: March 11, 2010

CERTIFICATION

I, Jeffrey D. Miller, certify that:

1. I have reviewed this annual report on Form 10-K for the year ended December 31, 2009 of Donegal Group Inc.;

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

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

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

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

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

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

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

or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

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

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

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

/s/ Jeffrey D. Miller

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

Date: March 11, 2010

Statement of President
Pursuant to Section 1350 of Title 18 of the United States Code

Pursuant to Section 1350 of Title 18 of the United States Code, I, Donald H. Nikolaus, the President of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2009 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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

Date: March 11, 2010

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

Pursuant to Section 1350 of Title 18 of the United States Code, I, Jeffrey D. Miller, Vice President and Chief Financial Officer of Donegal Group Inc. (the "Company"), hereby certify that, to the best of my knowledge:

1. The Company's Form 10-K Annual Report for the period ended December 31, 2009 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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

Date: March 11, 2010