

DONEGAL GROUP INC  
Form 10-Q  
August 09, 2010

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2010**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

**Commission file number 0-15341**

**Donegal Group Inc.**

(Exact name of registrant as specified in its charter)

Delaware

23-2424711

(State or other jurisdiction of  
incorporation or organization)

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

1195 River Road, P.O. Box 302, Marietta, PA 17547

(Address of principal executive offices) (Zip code)

(717) 426-1931

(Registrant's telephone number, including area code)

Not applicable

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) 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 whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller  
reporting company)

Smaller reporting  
company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 19,965,942 shares of Class A Common Stock, par value \$0.01 per share, and 5,576,775 shares of

Class B Common Stock, par value \$0.01 per share, outstanding on July 30, 2010.

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**Part I. Financial Information****Item 1. Financial Statements.****Donegal Group Inc. and Subsidiaries  
Consolidated Balance Sheets**

|  | <b>June 30, 2010</b><br>(Unaudited) | <b>December 31,</b><br><b>2009</b> |
|--|-------------------------------------|------------------------------------|
| <b>Assets</b>  |                                     |                                    |
| Investments  |                                     |                                    |
| Fixed maturities   |                                     |                                    |
| Held to maturity, at amortized cost                            | \$ 68,000,766                       | \$ 73,807,126                      |
| Available for sale, at fair value                              | 536,086,968                         | 517,703,672                        |
| Equity securities, available for sale, at fair value           | 14,136,602                          | 9,914,626                          |
| Investments in affiliates                                      | 9,142,992                           | 9,309,347                          |
| Short-term investments, at cost, which approximates fair value | 44,721,825                          | 56,100,415                         |
| <br>   |                                     |                                    |
| Total investments  | 672,089,153                         | 666,835,186                        |
| Cash   | 10,123,179                          | 12,923,898                         |
| Accrued investment income                                      | 6,435,842                           | 6,202,710                          |
| Premiums receivable  | 70,110,729                          | 61,187,021                         |
| Reinsurance receivable   | 93,795,397                          | 84,670,009                         |
| Deferred policy acquisition costs                              | 33,873,125                          | 32,844,179                         |
| Deferred tax asset, net  | 4,254,403                           | 5,086,949                          |
| Prepaid reinsurance premiums                                   | 62,141,500                          | 56,040,728                         |
| Property and equipment, net                                    | 6,440,764                           | 6,592,223                          |
| Accounts receivable securities                                 | 2,587,399                           | 588,292                            |
| Federal income taxes recoverable                               |                                     | 663,047                            |
| Other  | 1,965,582                           | 1,967,685                          |
| <br>   |                                     |                                    |
| Total assets   | \$ 963,817,073                      | \$ 935,601,927                     |
| <br>   |                                     |                                    |
| <b>Liabilities and Stockholders Equity</b>                     |                                     |                                    |
| <b>Liabilities</b>   |                                     |                                    |
| Unpaid losses and loss expenses                                | \$ 276,230,422                      | \$ 263,598,844                     |
| Unearned premiums  | 258,837,434                         | 241,821,419                        |
| Accrued expenses   | 9,279,023                           | 10,578,695                         |
| Reinsurance balances payable                                   | 3,256,349                           | 2,561,426                          |
| Federal income taxes payable                                   | 655,666                             |                                    |
| Cash dividends declared to stockholders                        |                                     | 2,798,378                          |
| Subordinated debentures  | 15,465,000                          | 15,465,000                         |
| Accounts payable securities                                    | 7,244,783                           | 6,828,873                          |
| Due to affiliate   | 2,043,935                           | 3,813,294                          |
| Drafts payable   | 1,324,145                           | 884,993                            |
| Other  | 1,601,958                           | 1,745,306                          |

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|   |                |                |
|---|----------------|----------------|
| Total liabilities   | 575,938,715    | 550,096,228    |
| <b>Stockholders Equity</b>  |                |                |
| 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 20,615,840 and 20,569,930 shares and outstanding 19,953,539 and 19,917,331 shares | 206,158        | 205,700        |
| 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  | 165,398,461    | 164,585,214    |
| Accumulated other comprehensive income  | 17,628,498     | 15,007,044     |
| Retained earnings   | 213,838,682    | 214,755,495    |
| Treasury stock  | (9,249,933)    | (9,104,246)    |
| Total stockholders equity   | 387,878,358    | 385,505,699    |
| Total liabilities and stockholders equity   | \$ 963,817,073 | \$ 935,601,927 |

See accompanying notes to consolidated financial statements.

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

|   | <b>Three Months Ended June 30,</b> |                   |
|---|------------------------------------|-------------------|
|   | <b>2010</b>                        | <b>2009</b>       |
| <b>Revenues:</b>                                  |                                    |                   |
| Net premiums earned                               | \$ 93,002,409                      | \$ 87,540,345     |
| Investment income, net of investment expenses     | 4,968,490                          | 5,266,161         |
| Net realized investment gains                     | 1,965,091                          | 445,140           |
| Lease income                                      | 229,490                            | 234,713           |
| Installment payment fees                          | 1,359,874                          | 1,308,620         |
| Other income                                      |                                    | 28,441            |
| <b>Total revenues</b>                             | <b>101,525,354</b>                 | <b>94,823,420</b> |
| <b>Expenses:</b>                                  |                                    |                   |
| Net losses and loss expenses                      | 68,509,616                         | 61,903,131        |
| Amortization of deferred policy acquisition costs | 16,146,000                         | 14,634,000        |
| Other underwriting expenses                       | 14,182,695                         | 12,527,331        |
| Policyholder dividends                            | 65,482                             | 91,682            |
| Interest  | 168,935                            | 198,467           |
| Other expenses                                    | 581,750                            | 335,281           |
| <b>Total expenses</b>                             | <b>99,654,478</b>                  | <b>89,689,892</b> |
| <br>  |                                    |                   |
| Income before income tax expense                  | 1,870,876                          | 5,133,528         |
| Income tax expense                                | 131,148                            | 745,904           |
| <br>  |                                    |                   |
| Net income  | \$ 1,739,728                       | \$ 4,387,624      |
| <br>  |                                    |                   |
| Earnings per common share:                        |                                    |                   |
| Class A common stock basic                        | \$ 0.07                            | \$ 0.18           |
| Class A common stock diluted                      | \$ 0.07                            | \$ 0.18           |
| Class B common stock basic and diluted            | \$ 0.06                            | \$ 0.16           |

**Consolidated Statements of Comprehensive Income**  
(Unaudited)

|  | <b>Three Months Ended June 30,</b> |              |
|--|------------------------------------|--------------|
|  | <b>2010</b>                        | <b>2009</b>  |
| Net income                             | \$ 1,739,728                       | \$ 4,387,624 |
| Other comprehensive income, net of tax |                                    |              |

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|  |              |              |
|--|--------------|--------------|
| Unrealized income on securities:                               |              |              |
| Unrealized holding income during the period, net of income tax | 4,383,766    | 1,413,555    |
| Reclassification adjustment, net of income tax                 | (1,296,960)  | (289,341)    |
| Other comprehensive income                                     | 3,086,806    | 1,124,214    |
| Comprehensive income   | \$ 4,826,534 | \$ 5,511,838 |

See accompanying notes to consolidated financial statements.

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

|   | <b>Six Months Ended June 30,</b> |                     |
|---|----------------------------------|---------------------|
|   | <b>2010</b>                      | <b>2009</b>         |
| <b>Revenues:</b>                                  |                                  |                     |
| Net premiums earned                               | \$ 184,374,505                   | \$ 175,889,888      |
| Investment income, net of investment expenses     | 9,898,981                        | 10,623,750          |
| Net realized investment gains                     | 1,986,603                        | 703,995             |
| Lease income                                      | 455,997                          | 456,334             |
| Installment payment fees                          | 2,660,116                        | 2,608,376           |
| Other income                                      |                                  | 42,691              |
| <b>Total revenues</b>                             | <b>199,376,202</b>               | <b>190,325,034</b>  |
| <b>Expenses:</b>                                  |                                  |                     |
| Net losses and loss expenses                      | 136,491,102                      | 127,852,296         |
| Amortization of deferred policy acquisition costs | 32,161,000                       | 29,367,000          |
| Other underwriting expenses                       | 26,815,711                       | 25,203,963          |
| Policyholder dividends                            | 244,783                          | 335,211             |
| Interest  | 353,693                          | 1,403,245           |
| Other expenses                                    | 1,163,499                        | 817,536             |
| <b>Total expenses</b>                             | <b>197,229,788</b>               | <b>184,979,251</b>  |
| <br>  |                                  |                     |
| Income before income tax expense                  | 2,146,414                        | 5,345,783           |
| Income tax expense                                | 171,928                          | 788,355             |
| <br>  |                                  |                     |
| <b>Net income</b>                                 | <b>\$ 1,974,486</b>              | <b>\$ 4,557,428</b> |
| <br>  |                                  |                     |
| Earnings per common share:                        |                                  |                     |
| Class A common stock    basic                     | \$ 0.08                          | \$ 0.18             |
| Class A common stock    diluted                   | \$ 0.08                          | \$ 0.18             |
| Class B common stock    basic and diluted         | \$ 0.07                          | \$ 0.16             |

**Consolidated Statements of Comprehensive Income**  
(Unaudited)

|  | <b>Six Months Ended June 30,</b> |              |
|--|----------------------------------|--------------|
|  | <b>2010</b>                      | <b>2009</b>  |
| Net income                             | \$ 1,974,486                     | \$ 4,557,428 |
| Other comprehensive income, net of tax |                                  |              |

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|  |              |               |
|--|--------------|---------------|
| Unrealized income on securities:                               |              |               |
| Unrealized holding income during the period, net of income tax | 3,932,612    | 5,920,430     |
| Reclassification adjustment, net of income tax                 | (1,311,158)  | (457,597)     |
| Other comprehensive income                                     | 2,621,454    | 5,462,833     |
| Comprehensive income   | \$ 4,595,940 | \$ 10,020,261 |

See accompanying notes to consolidated financial statements.

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**Donegal Group Inc. and Subsidiaries**  
**Consolidated Statement of Stockholders' Equity**  
(Unaudited)  
**Six Months Ended June 30, 2010**

|   | Class A<br>Shares | Class B<br>Shares | Class A<br>Amount | Class B<br>Amount | Additional<br>Paid-In<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income | Retained<br>Earnings | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|---|-------------------|-------------------|-------------------|-------------------|----------------------------------|---|----------------------|-------------------|----------------------------------|
| Balance,<br>December 31,<br>2009                                    | 20,569,930        | 5,649,240         | \$ 205,700        | \$ 56,492         | \$ 164,585,214                   | \$ 15,007,044                                   | \$ 214,755,495       | \$ (9,104,246)    | \$ 385,505,600                   |
| Issuance of<br>common stock<br>for stock<br>compensation<br>(units) | 45,910            |                   | 458               |                   | 790,175                          |   |                      |                   | 790,600                          |
| Net income  |                   |                   |                   |                   |                                  |   | 1,974,486            |                   | 1,974,486                        |
| Cash dividends<br>declared  |                   |                   |                   |                   |                                  |   | (2,868,227)          |                   | (2,868,227)                      |
| Reversal of stock<br>options  |                   |                   |                   |                   | 23,072                           |   | (23,072)             |                   |                                  |
| Repurchase of<br>treasury stock                                     |                   |                   |                   |                   |                                  |   |                      | (145,687)         | (145,687)                        |
| Other<br>comprehensive<br>income                                    |                   |                   |                   |                   |                                  | 2,621,454                                       |                      |                   | 2,621,454                        |
| Balance,<br>June 30, 2010   | 20,615,840        | 5,649,240         | \$ 206,158        | \$ 56,492         | \$ 165,398,461                   | \$ 17,628,498                                   | \$ 213,838,682       | \$ (9,249,933)    | \$ 387,878,300                   |

See accompanying notes to consolidated financial statements.

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

|   | <b>Six Months Ended June 30,</b> |              |
|---|----------------------------------|--------------|
|   | <b>2010</b>                      | <b>2009</b>  |
| <b>Cash Flows from Operating Activities:</b>                                      |                                  |              |
| Net income  | \$ 1,974,486                     | \$ 4,557,428 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                  |              |
| Depreciation and amortization   | 1,257,660                        | 1,322,211    |
| Net realized investment gains   | (1,986,603)                      | (703,995)    |
| Equity loss (income)  | 197,545                          | (42,691)     |
| Changes in assets and liabilities:  |                                  |              |
| Losses and loss expenses  | 12,631,578                       | 9,687,639    |
| Unearned premiums   | 17,016,015                       | 9,725,766    |
| Premiums receivable   | (8,923,708)                      | (5,052,587)  |
| Deferred acquisition costs  | (1,028,946)                      | (1,164,877)  |
| Deferred income taxes   | (579,005)                        | 78,709       |
| Reinsurance receivable  | (9,125,388)                      | (5,047,189)  |
| Prepaid reinsurance premiums  | (6,100,772)                      | (4,031,695)  |
| Accrued investment income   | (233,132)                        | 6,518        |
| Due to affiliate  | (1,769,359)                      | (2,392,632)  |
| Reinsurance balances payable  | 694,923                          | 2,051,245    |
| Current income taxes  | 1,318,713                        | 2,451,699    |
| Accrued expenses  | (1,299,672)                      | (4,220,349)  |
| Other, net  | 297,926                          | 384,493      |
| Net adjustments   | 2,367,775                        | 3,052,265    |
| Net cash provided by operating activities   | 4,342,261                        | 7,609,693    |
| <b>Cash Flows from Investing Activities:</b>                                      |                                  |              |
| Purchases of fixed maturities:  |                                  |              |
| Available for sale  | (80,020,763)                     | (72,564,308) |
| Purchases of equity securities, available for sale                                | (11,014,460)                     | (13,404,392) |
| Maturity of fixed maturities:   |                                  |              |
| Held to maturity  | 5,612,123                        | 18,252,970   |
| Available for sale  | 39,093,985                       | 22,158,494   |
| Sales of fixed maturities:  |                                  |              |
| Available for sale  | 26,454,158                       | 10,037,415   |
| Sales of equity securities, available for sale                                    | 6,765,783                        | 13,070,887   |
| Payments to Sheboygan policyholders   |                                  | (5,556,650)  |
| Net increase in investment in affiliates  |                                  | (50,000)     |
| Net purchases of property and equipment   | (390,737)                        | (666,968)    |
| Net sales of short-term investments   | 11,378,590                       | 31,642,178   |

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|   |               |                |
|---|---------------|----------------|
| Net cash (used in) provided by investing activities | (2,121,321)   | 2,919,626      |
| <b>Cash Flows from Financing Activities:</b>        |               |                |
| Cash dividends paid                                 | (5,666,605)   | (5,400,717)    |
| Issuance of common stock                            | 790,633       | 720,816        |
| Purchase of treasury stock                          | (145,687)     | (198,879)      |
| Net cash used in financing activities               | (5,021,659)   | (4,878,780)    |
| Net (decrease) increase in cash                     | (2,800,719)   | 5,650,539      |
| Cash at beginning of period                         | 12,923,898    | 1,830,954      |
| Cash at end of period                               | \$ 10,123,179 | \$ 7,481,493   |
| Cash paid during period Interest                    | \$ 337,677    | \$ 481,430     |
| Net cash received during period Taxes               | \$ (600,000)  | \$ (1,751,090) |

See accompanying notes to consolidated financial statements.

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

**1 Organization**

Donegal Mutual Insurance Company ( Donegal Mutual ) organized us as a downstream insurance holding company on August 26, 1986. Our six insurance subsidiaries and Donegal Mutual conduct business as the Donegal Insurance Group. The Donegal Insurance Group writes personal and commercial lines of property and casualty insurance exclusively through a network of independent insurance agents in 20 Mid-Atlantic, Midwestern, New England and Southeastern states. The personal lines products consist primarily of homeowners and private passenger automobile policies. The commercial lines products consist primarily of commercial automobile, commercial multi-peril and workers' compensation policies.

Our insurance subsidiaries are 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 ). We also own approximately 48% of the outstanding stock of Donegal Financial Services Corporation ( DFSC ), a unitary thrift holding company that owns Province Bank FSB. Donegal Mutual owns the remaining approximately 52% of the outstanding stock of DFSC.

At June 30, 2010, Donegal Mutual held approximately 42% of our outstanding Class A common stock and approximately 75% of our outstanding Class B common stock.

Atlantic States and Donegal Mutual are parties to a pooling agreement under which each company places all of its direct written business in the pool and both companies share the underwriting results of the pool as provided in the pooling agreement, excluding certain reinsurance Donegal Mutual assumes from our five other insurance subsidiaries. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Donegal Mutual and Atlantic States amended the pooling agreement effective March 1, 2008 to increase Atlantic States' share of the results of the pool to 80% and to decrease Donegal Mutual's share of the results of the pool to 20% beginning on that date. See Note 4 Reinsurance for more information regarding the pooling agreement.

On February 23, 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 prices prevailing from time to time in the open market subject to the provisions of applicable SEC rules and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program during the three months ended June 30, 2010 and 2009, respectively. We purchased 9,702 and no shares of our Class A common stock under this program during the six months ended June 30, 2010 and 2009, respectively. We have purchased a total of 17,371 shares of our Class A common stock under this program through June 30, 2010.

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 Donegal Mutual assumes from Southern Mutual in the 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.

In April 2010, DFSC and certain of its affiliates, including Donegal Mutual and us, and Union National Financial Corporation ( UNNF ) executed an agreement pursuant to which DFSC and UNNF would merge, with DFSC as the surviving company in the merger. The merger is subject to a number of conditions, including approval of the merger by the holders of 80% of the outstanding shares of UNNF and the approval of various federal bank regulatory agencies. Under the agreement, Province Bank FSB, which DFSC owns, and Union National Community Bank, which UNNF owns, would also merge. The combined bank would



have total assets of approximately \$600 million and would have 13 branch locations in Lancaster County, Pennsylvania. The companies expect to complete the mergers in the fourth quarter of 2010.

In July 2010, we executed an agreement pursuant to which we will acquire all of the outstanding stock of Michigan Insurance Company ( MICO ), an 83.6%-owned subsidiary of West Bend Mutual Insurance Company ( WBM ). MICO writes various lines of property and casualty insurance exclusively in the State of Michigan. MICO had direct written premiums of \$106.6 million and net written premiums of \$26.7 million for the year ended December 31, 2009. The purchase price will be calculated based on the United States generally accepted accounting principles ( GAAP ) book value of MICO as of the closing date of the acquisition. We estimate that the purchase price payable to the shareholders of MICO will be approximately \$39 million. The acquisition is subject to a number of conditions, including the approval of the Insurance Department of the State of Michigan. We expect to complete the acquisition in the fourth quarter of 2010.

## **2 Basis of Presentation**

Our financial information for the interim periods included in this Form 10-Q Report is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments that, in the opinion of our management, are necessary for a fair presentation of our financial position, results of operations and cash flows for those interim periods. Our results of operations for the six months ended June 30, 2010 are not necessarily indicative of the results of operations we expect for the year ending December 31, 2010.

You should read these interim financial statements in conjunction with the financial statements and notes thereto contained in our Annual Report on Form 10-K for the year ended December 31, 2009.

### 3 Earnings Per Share

We have two classes of common stock, which we refer to as our Class A common stock and our Class B common stock. Our certificate of incorporation provides that whenever our board of directors declares a dividend on our Class B common stock, our board of directors must also declare a dividend on our Class A common stock that is payable at the same time to holders as of the same record date at a rate that is at least 10% greater than the rate at which our board of directors declared the dividend on our Class B common stock. Accordingly, we use the two-class method to compute our 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 we have declared and an allocation of our remaining undistributed earnings using a participation percentage that reflects the dividend rights of each class. The table below presents for the periods indicated a reconciliation of the numerators and denominators we used to compute basic and diluted net income per share for each class of common stock:

#### For the Three Months Ended June 30:

|   | 2010                                  |           | 2009       |           |
|---|---------------------------------------|-----------|------------|-----------|
|   | Class A                               | Class B   | Class A    | Class B   |
|   | (in thousands, except per share data) |           |            |           |
| Basic net income per share:   |                                       |           |            |           |
| Numerator:  |                                       |           |            |           |
| Allocation of net income  | \$ 1,396                              | \$ 343    | \$ 3,507   | \$ 881    |
| Denominator:  |                                       |           |            |           |
| Weighted-average shares outstanding   | 19,953,539                            | 5,576,775 | 19,898,680 | 5,576,775 |
| Basic net income per share  | \$ 0.07                               | \$ 0.06   | \$ 0.18    | \$ 0.16   |
| Diluted net income per share:   |                                       |           |            |           |
| Numerator:  |                                       |           |            |           |
| Allocation of net income  | \$ 1,396                              | \$ 343    | \$ 3,507   | \$ 881    |
| Denominator:  |                                       |           |            |           |
| Number of shares used in basic computations   | 19,953,539                            | 5,576,775 | 19,898,680 | 5,576,775 |
| Weighted-average effect of dilutive securities<br>Director and employee stock options |                                       |           |            |           |
| Number of shares used in per share<br>computations                                    | 19,953,539                            | 5,576,775 | 19,898,680 | 5,576,775 |
| Diluted net income per share  | \$ 0.07                               | \$ 0.06   | \$ 0.18    | \$ 0.16   |

#### For the Six Months Ended June 30:

|                             | 2010                                  |         | 2009    |         |
|-----------------------------|---------------------------------------|---------|---------|---------|
|                             | Class A                               | Class B | Class A | Class B |
|                             | (in thousands, except per share data) |         |         |         |
| Basic net income per share: |                                       |         |         |         |
| Numerator:                  |                                       |         |         |         |

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|   |            |           |            |           |
|---|------------|-----------|------------|-----------|
| Allocation of net income  | \$ 1,584   | \$ 390    | \$ 3,642   | \$ 915    |
| Denominator:  |            |           |            |           |
| Weighted-average shares outstanding   | 19,942,153 | 5,576,775 | 19,891,096 | 5,576,775 |
| Basic net income per share  | \$ 0.08    | \$ 0.07   | \$ 0.18    | \$ 0.16   |
| Diluted net income per share:   |            |           |            |           |
| Numerator:  |            |           |            |           |
| Allocation of net income  | \$ 1,584   | \$ 390    | \$ 3,642   | \$ 915    |
| Denominator:  |            |           |            |           |
| Number of shares used in basic computations   | 19,942,153 | 5,576,775 | 19,891,096 | 5,576,775 |
| Weighted-average effect of dilutive securities<br>Director and employee stock options |            |           |            |           |
| Number of shares used in per share<br>computations                                    | 19,942,153 | 5,576,775 | 19,891,096 | 5,576,775 |
| Diluted net income per share  | \$ 0.08    | \$ 0.07   | \$ 0.18    | \$ 0.16   |



We did not include outstanding options to purchase the following number of shares of Class A common stock in our computation of diluted earnings per share because the exercise price of the options was greater than the average market price during the period:

|                           | Three Months Ended |           | Six Months Ended |           |
|---------------------------|--------------------|-----------|------------------|-----------|
|                           | June 30,           |           | June 30,         |           |
|                           | 2010               | 2009      | 2010             | 2009      |
| Number of shares excluded | 3,290,099          | 3,413,932 | 3,290,099        | 3,423,432 |

#### 4 Reinsurance

Atlantic States and Donegal Mutual have participated in a pooling agreement since 1986 under which each company places all of its direct written business into the pool, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. 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. Donegal Mutual and Atlantic States amended the pooling agreement effective March 1, 2008 to increase Atlantic States' share of the results of the pool to 80% beginning on that date.

Atlantic States, Southern and Donegal Mutual purchase third-party reinsurance on a combined basis. Le Mars, Peninsula and Sheboygan have separate third-party reinsurance programs that provide similar types of coverage and that are commensurate with their relative size and risk exposures. Our insurance subsidiaries place reinsurance with various reinsurers, all of which, consistent with Donegal Insurance Group's requirements, have an A.M. Best rating of A- (Excellent) or better or, with respect to foreign reinsurers, have a financial condition that, in the opinion of our management, is equivalent to a company with at least an A- rating. The following information describes the external reinsurance our insurance subsidiaries have in place during 2010 and 2009:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of reinsurance agreements, over a set retention (\$750,000), and

catastrophe reinsurance, under which Donegal Mutual, Atlantic States and Southern recover, through a series of reinsurance agreements, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention (\$3.0 million).

Our insurance subsidiaries and Donegal Mutual also purchase facultative reinsurance to cover exposures from losses that exceed the limits provided by their reinsurance agreements with third parties.

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

We made no significant changes to our third-party reinsurance or the reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the six months ended June 30, 2010.

**5 Investments**

The amortized cost and estimated fair values of our fixed maturities and equity securities at June 30, 2010 are as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
|   | (in thousands)    |                              |                               |                            |
| <b>Held to Maturity</b>   |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 1,000          | \$ 97                        | \$                            | \$ 1,097                   |
| Obligations of states and political subdivisions                                      | 60,045            | 3,561                        |                               | 63,606                     |
| Corporate securities  | 4,245             | 37                           | 4                             | 4,278                      |
| Residential mortgage-backed securities  | 2,711             | 62                           | 4                             | 2,769                      |
| Totals  | \$ 68,001         | \$ 3,757                     | \$ 8                          | \$ 71,750                  |

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
|   | (in thousands)    |                              |                               |                            |
| <b>Available for Sale</b>   |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 36,378         | \$ 606                       | \$ 58                         | \$ 36,926                  |
| Obligations of states and political subdivisions                                      | 376,303           | 14,315                       | 866                           | 389,752                    |
| Corporate securities  | 28,613            | 808                          | 15                            | 29,406                     |
| Residential mortgage-backed securities  | 76,808            | 3,247                        | 52                            | 80,003                     |
| Fixed maturities  | 518,102           | 18,976                       | 991                           | 536,087                    |
| Equity securities   | 8,051             | 6,451                        | 365                           | 14,137                     |
| Totals  | \$ 526,153        | \$ 25,427                    | \$ 1,356                      | \$ 550,224                 |

The amortized cost and estimated fair values of our fixed maturities and equity securities at December 31, 2009 are as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|----------------------------|
|   | (in thousands)    |                              |                               |                            |
| <b>Held to Maturity</b>   |                   |                              |                               |                            |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 2,000          | \$ 80                        | \$                            | \$ 2,080                   |
| Obligations of states and political subdivisions                                      | 61,736            | 3,011                        | 24                            | 64,723                     |
| Corporate securities  | 6,243             | 72                           | 13                            | 6,302                      |
| Residential mortgage-backed securities  | 3,828             | 73                           |                               | 3,901                      |
| Totals  | \$ 73,807         | \$ 3,236                     | \$ 37                         | \$ 77,006                  |

|  | Gross | Gross | Estimated |
|--|-------|-------|-----------|
|--|-------|-------|-----------|

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|  | Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|---------------------|----------------------|---------------|
|  | (in thousands)    |                     |                      |               |
| <b>Available for Sale</b>  |                   |                     |                      |               |
| U.S. Treasury securities and obligations of U.S.<br>government corporations and agencies | \$ 41,061         | \$ 154              | \$ 585               | \$ 40,630     |
| Obligations of states and political subdivisions   | 346,799           | 12,587              | 1,019                | 358,367       |
| Corporate securities   | 26,972            | 866                 | 72                   | 27,766        |
| Residential mortgage-backed securities   | 88,914            | 2,357               | 330                  | 90,941        |
| Fixed maturities   | 503,746           | 15,964              | 2,006                | 517,704       |
| Equity securities  | 3,804             | 6,339               | 228                  | 9,915         |
| Totals   | \$ 507,550        | \$ 22,303           | \$ 2,234             | \$ 527,619    |

The amortized cost and estimated fair value of our fixed maturities at June 30, 2010, 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<br>Cost<br>(in thousands) | Estimated<br>Fair<br>Value |
|--|-------------------------------------|----------------------------|
| <b>Held to maturity</b>                |                                     |                            |
| Due in one year or less                | \$ 3,995                            | \$ 4,032                   |
| Due after one year through five years  | 13,845                              | 14,744                     |
| Due after five years through ten years | 45,675                              | 48,358                     |
| Due after ten years                    | 1,775                               | 1,847                      |
| Residential mortgage-backed securities | 2,711                               | 2,769                      |
| <b>Total held to maturity</b>          | <b>\$ 68,001</b>                    | <b>\$ 71,750</b>           |
| <b>Available for sale</b>              |                                     |                            |
| Due in one year or less                | \$ 15,460                           | \$ 15,664                  |
| Due after one year through five years  | 84,130                              | 87,091                     |
| Due after five years through ten years | 110,446                             | 114,540                    |
| Due after ten years                    | 231,258                             | 238,789                    |
| Residential mortgage-backed securities | 76,808                              | 80,003                     |
| <b>Total available for sale</b>        | <b>\$ 518,102</b>                   | <b>\$ 536,087</b>          |

Gross realized gains and losses from investments before applicable income taxes are as follows:

|                               | Three Months Ended<br>June 30, |               | Six Months Ended<br>June 30, |               |
|-------------------------------|--------------------------------|---------------|------------------------------|---------------|
|                               | 2010                           | 2009          | 2010                         | 2009          |
|                               | (in thousands)                 |               | (in thousands)               |               |
| <b>Gross realized gains:</b>  |                                |               |                              |               |
| Fixed maturities              | \$ 1,547                       | \$ 55         | \$ 1,631                     | \$ 133        |
| Equity securities             | 501                            | 363           | 613                          | 619           |
|                               | <b>\$ 2,048</b>                | <b>\$ 418</b> | <b>\$ 2,244</b>              | <b>\$ 752</b> |
| <b>Gross realized losses:</b> |                                |               |                              |               |
| Fixed maturities              | \$ 5                           | \$ 1          | \$ 179                       | \$ 1          |
| Equity securities             | 78                             | (28)          | 78                           | 47            |
|                               | 83                             | (27)          | 257                          | 48            |
| <b>Net realized gains</b>     | <b>\$ 1,965</b>                | <b>\$ 445</b> | <b>\$ 1,987</b>              | <b>\$ 704</b> |

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at June 30, 2010 as follows:

|   | Less than 12 months |                   | 12 months or longer |                   |
|---|---------------------|-------------------|---------------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses |
|   | (in thousands)      |                   |                     |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$                  | \$                | \$ 3,233            | \$ 58             |
| Obligations of states and political subdivisions                                      | 15,705              | 153               | 17,144              | 713               |
| Corporate securities  |                     |                   | 735                 | 19                |
| Residential mortgage-backed securities  | 2,079               | 56                |                     |                   |
| Equity securities   | 5,287               | 365               |                     |                   |
| Total   | \$ 23,071           | \$ 574            | \$ 21,112           | \$ 790            |

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 |
|   | (in thousands)      |                   |                     |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 26,704           | \$ 585            | \$                  | \$                |
| Obligations of states and political subdivisions                                      | 17,971              | 257               | 29,582              | 787               |
| Corporate securities  | 1,284               | 24                | 667                 | 62                |
| Residential mortgage-backed securities  | 23,514              | 329               | 478                 |                   |
| Equity securities   | 2,140               | 227               |                     |                   |
| Total   | \$ 71,613           | \$ 1,423          | \$ 30,727           | \$ 849            |

Of our total fixed maturity securities with an unrealized loss at June 30, 2010, we classified 29 securities with a fair value of \$38.1 million and an unrealized loss of \$991,033 as available-for-sale and carried them at fair value on our balance sheet, while we classified three securities with a fair value of \$824,743 and an unrealized loss of \$7,761 as held-to-maturity on our balance sheet and carried them at amortized cost.

Of our total fixed maturity securities with an unrealized loss at December 31, 2009, we classified 70 securities with a fair value of \$97.9 million and an unrealized loss of \$2.1 million as available-for-sale and carried them at fair value on our balance sheet, while we classified three securities with a fair value of \$2.3 million and an unrealized loss of \$37,097 as held-to-maturity on our balance sheet and carried them at amortized cost.

We have no direct exposure to sub-prime residential mortgage-backed securities and hold no collateralized debt obligations. Substantially all of the unrealized losses in our fixed maturity investment portfolio have resulted from general market conditions and the related impact on our fixed maturity investment valuations. We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, when we consider the decline in value of an individual investment to be other than temporary, we write the investment down to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations. We individually monitor all investments for other-than-temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in such an unrealized loss position for more than six months, we assume there has been an other-than-temporary decline in value. We held nine equity securities that were in an unrealized loss position at June 30, 2010. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we consider 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 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 security prior to recovery. If 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 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. To determine whether a credit loss has occurred, we compare 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 a credit loss to have occurred. If we consider a credit loss to have 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 the fair value of the investment being significantly below its cost, whether the financial condition of the issuer of the security is deteriorating, the occurrence of industry, company and geographic events that have negatively impacted the

value of the security and rating agency downgrades. We determined that no investments with fair values below cost had declined on an other-than-temporary basis during the first six months of 2010 and 2009, respectively.

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 our affiliates using the equity method of accounting, under which we record our investment at cost, with adjustments for our share of our affiliates' earnings and losses as well as changes in our affiliates' equity due to unrealized gains and losses.



**6 Segment Information**

We evaluate the performance of our personal lines and commercial lines segments based upon the underwriting results of our insurance subsidiaries using statutory accounting principles prescribed or permitted by various state insurance departments ( SAP ). Our management uses SAP to measure the performance of our insurance subsidiaries instead of GAAP. Financial data by segment is as follows:

|                                 | Three Months Ended<br>June 30, |               |
|---------------------------------|--------------------------------|---------------|
|                                 | 2010                           | 2009          |
|                                 | (in thousands)                 |               |
| Revenues:                       |                                |               |
| Premiums earned:                |                                |               |
| Commercial lines                | \$ 28,903                      | \$ 28,065     |
| Personal lines                  | 64,099                         | 59,604        |
| <br>Net premiums earned         | <br>93,002                     | <br>87,669    |
| GAAP adjustments                |                                | (129)         |
| <br>GAAP premiums earned        | <br>93,002                     | <br>87,540    |
| Net investment income           | 4,968                          | 5,266         |
| Realized investment gains       | 1,965                          | 445           |
| Other                           | 1,590                          | 1,572         |
| <br>Total revenues              | <br>\$ 101,525                 | <br>\$ 94,823 |
| <br>Income before income taxes: |                                |               |
| Underwriting income (loss):     |                                |               |
| Commercial lines                | \$ 1,830                       | \$ 1,603      |
| Personal lines                  | (9,430)                        | (4,362)       |
| <br>SAP underwriting loss       | <br>(7,600)                    | <br>(2,759)   |
| GAAP adjustments                | 1,699                          | 1,143         |
| <br>GAAP underwriting loss      | <br>(5,901)                    | <br>(1,616)   |
| Net investment income           | 4,968                          | 5,266         |
| Realized investment gains       | 1,965                          | 445           |
| Other                           | 839                            | 1,039         |
| <br>Income before income taxes  | <br>\$ 1,871                   | <br>\$ 5,134  |
| <br><br><br>                    |                                |               |
|                                 | Six Months Ended<br>June 30,   |               |
|                                 | 2010                           | 2009          |
|                                 | (in thousands)                 |               |
| Revenues:                       |                                |               |
| Premiums earned:                |                                |               |
| Commercial lines                | \$ 56,591                      | \$ 57,324     |

|                             |            |            |
|-----------------------------|------------|------------|
| Personal lines              | 127,811    | 119,011    |
| Net premiums earned         | 184,402    | 176,335    |
| GAAP adjustments            | (28)       | (445)      |
| GAAP premiums earned        | 184,374    | 175,890    |
| Net investment income       | 9,899      | 10,624     |
| Realized investment gains   | 1,987      | 704        |
| Other                       | 3,116      | 3,107      |
| Total revenues              | \$ 199,376 | \$ 190,325 |
| Income before income taxes: |            |            |
| Underwriting income (loss): |            |            |
| Commercial lines            | \$ (761)   | \$ 2,021   |
| Personal lines              | (12,267)   | (10,229)   |
| SAP underwriting loss       | (13,028)   | (8,208)    |
| GAAP adjustments            | 1,690      | 1,339      |
| GAAP underwriting loss      | (11,338)   | (6,869)    |
| Net investment income       | 9,899      | 10,624     |
| Realized investment gains   | 1,987      | 704        |
| Other                       | 1,598      | 887        |
| Income before income taxes  | \$ 2,146   | \$ 5,346   |

## 7 Subordinated Debentures

On October 29, 2003, we received \$10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At June 30, 2010, the interest rate on the debentures was 4.18%.

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 June 30, 2010, the interest rate on the debentures was 4.33%.

## 8 Share Based Compensation

We measure all share-based payments to employees, including grants of stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. 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 utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility.

We charged compensation expense for our stock compensation plans against income before income taxes of \$60,824 and \$48,691 for the three months ended June 30, 2010 and 2009, respectively, with a corresponding income tax benefit of \$20,680 and \$17,042, respectively. We charged compensation expense for our stock compensation plans against income before income taxes of \$120,985 and \$110,391 for the six months ended June 30, 2010 and 2009, respectively, with a corresponding income tax benefit of \$41,135 and \$38,637, respectively. As of June 30, 2010, our total unrecognized compensation cost related to nonvested share-based compensation granted under our stock compensation plans was \$80,797. We expect to recognize this cost over a weighted average period of 0.7 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 Donegal Mutual. This accounting applies to options we grant to employees and directors of Donegal Mutual, the employer of a majority of the employees that provide services to us. We recorded implied dividends of \$0 and \$5,298 for the three months ended June 30, 2010 and 2009, respectively. We recorded implied dividends of \$23,072 and \$32,923 for the six months ended June 30, 2010 and 2009, respectively.

We received no cash from option exercises under all stock option compensation plans for the six months ended June 30, 2010 and 2009. We realized no tax benefits for the tax deductions from option exercises for the six months ended June 30, 2010 and 2009.

## 9 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 obtain from independent pricing services through a bank trustee. 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. During the first six months of 2010, we classified one equity security as Level 3. We utilized a fair value model that incorporated significant other unobservable inputs, such as estimated volatility, to estimate the equity security's fair value. Pursuant to terms of an initial public offering, we are restricted from selling this security for a specified period, and the fair value we determined as of June 30, 2010 reflects this restriction. During the first six months of 2010, we recorded unrealized income of \$94,419 related to this security in other comprehensive income.

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 was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for our fixed maturity and equity investments. 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 the pricing services provide 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 June 30, 2010 and December 31, 2009, 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 the pricing services provided as of June 30, 2010 and December 31, 2009, 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 the balance sheet for premium and reinsurance receivables and payables approximate their fair values. The carrying amounts reported in the balance sheet for our subordinated debentures approximate their fair values due to their variable rate nature, and there has been no change in our creditworthiness.

We evaluate our assets and liabilities on a recurring basis to determine the appropriate level at which to classify them for each reporting period. The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of June 30, 2010:

|   | 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) |
| (in thousands)  |            |  |   |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 36,926  | \$   | \$ 36,926                                     | \$  |
| Obligations of states and political subdivisions                                      | 389,752    |  | 389,752                                       |   |
| Corporate securities  | 29,406     |  | 29,406  |   |
| Residential mortgage-backed securities  | 80,003     |  | 80,003  |   |
| Equity securities   | 14,137     | 6,627  | 1,184   | 6,326                                     |

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|        |            |          |            |          |
|--------|------------|----------|------------|----------|
| Totals | \$ 550,224 | \$ 6,627 | \$ 537,271 | \$ 6,326 |
|--------|------------|----------|------------|----------|

We did not have any transfers between Levels 1 and 2 during the quarter ended June 30, 2010.

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The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of December 31, 2009:

|   | Fair Value | Fair Value Measurements Using                                 |   |   |
|---|------------|---|---|---|
|   |            | Quoted Prices in Active Markets or Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|   |            |   |   |   |
|   |            | (in thousands)  |   |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 40,630  | \$  | \$ 40,630                                     | \$  |
| Obligations of states and political subdivisions                                      | 358,366    |   | 358,366                                       |   |
| Corporate securities  | 27,766     |   | 27,766  |   |
| Residential mortgage-backed securities  | 90,941     |   | 90,941  |   |
| Equity securities   | 9,915      | 2,426   | 1,257   | 6,232                                     |
| Totals  | \$ 527,618 | \$ 2,426  | \$ 518,960                                    | \$ 6,232                                  |

The following table presents a roll forward of the significant unobservable inputs for our Level 3 securities for the three months ended June 30, 2010:

|                       | (in thousands) |
|-----------------------|----------------|
| Balance, March 31     | \$ 5,852       |
| Net unrealized income | 474            |
| Balance, June 30      | \$ 6,326       |

The following table presents a roll forward of the significant unobservable inputs for our Level 3 securities for the six months ended June 30, 2010:

|                       | (in thousands) |
|-----------------------|----------------|
| Balance, January 1    | \$ 6,232       |
| Net unrealized income | 94             |
| Balance, June 30      | \$ 6,326       |

## 10 Income Taxes

As of June 30, 2010 and December 31, 2009, respectively, we had no material unrecognized tax benefits or accrued interest and penalties. The Internal Revenue Service examined our 2006 federal tax return and made no adjustments to the taxes we had reported. Tax years 2007, 2008 and 2009 remained open for examination as of June 30, 2010.

## 11 Impact of New Accounting Standards

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. ASC subtopic 860-20 amends the derecognition guidance in Statement 140 and eliminates the concept of qualifying special-purpose entities. ASC subtopic 860-20 is effective for fiscal years and interim periods beginning after November 15, 2009. We adopted ASC subtopic 860-20 on January 1, 2010. The adoption did not impact our financial position or results of operations.

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. ASC subtopic 810-10 requires ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE. ASC subtopic 810-10 amends interpretation 46(R) to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE. ASC subtopic 810-10 is

effective for fiscal years and interim periods beginning after November 15, 2009. We adopted ASC subtopic 810-10 on January 1, 2010. The adoption did not impact our financial position or results of operations.

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends ASC subtopic 820-10 by requiring new, and clarifying existing, fair value disclosures. ASU 2010-06 is effective for the interim period ended March 31, 2010, except for certain new Level 3 rollforward disclosures, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. We have included herein the disclosures ASU 2010-06 requires for the first half of 2010, and we will include the Level 3 rollforward disclosures ASU 2010-06 requires for fiscal years and interim periods beginning after December 31, 2010.

## **12 Subsequent Event**

In July 2010, we executed an agreement pursuant to which we will acquire all of the outstanding stock of MICO, an 83.6%-owned subsidiary of WBM. MICO writes various lines of property and casualty insurance exclusively in the State of Michigan. MICO had direct written premiums of \$106.6 million and net written premiums of \$26.7 million for the year ended December 31, 2009. The purchase price will be calculated based on the GAAP book value of MICO as of the closing date of the acquisition. We estimate that the purchase price payable to the shareholders of MICO will be approximately \$39 million. The acquisition is subject to a number of conditions, including the approval of the Insurance Department of the State of Michigan. We expect to complete the acquisition in the fourth quarter of 2010.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

You should read the following information in conjunction with the historical financial information and the notes thereto included in this Quarterly Report on Form 10-Q and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2009.

### **Critical Accounting Policies and Estimates**

We combine our financial statements with those of our insurance subsidiaries and present our financial statements on a consolidated basis in accordance with GAAP.

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures that we report in our 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 in the value of investments and policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the amounts estimated. We regularly review these estimates and reflect any adjustment we consider necessary in our current results of operations.

#### **Liability for Unpaid Losses and Loss Expenses**

Liabilities for unpaid 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 the insurer then knows. An insurer recognizes at the time it establishes its estimates that its ultimate liability for unpaid losses and loss expenses will exceed or be less than those estimates. Our insurance subsidiaries base their estimates of liabilities for unpaid losses and loss expenses on assumptions as to future loss trends and expected claims severity, judicial theories of liability and other factors, including prevailing economic conditions. 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 adjust their estimates of liability. Our insurance subsidiaries reflect any adjustments to their liabilities for unpaid losses and loss expenses in their results of operations for the period in which our insurance subsidiaries change their estimates.

Our insurance subsidiaries maintain liabilities for the payment of unpaid losses and loss expenses with respect to both reported and unreported claims. It is the intent of our insurance subsidiaries that their liabilities for loss expenses will cover the ultimate costs of settling all losses, including investigation and litigation costs from those losses. Our insurance subsidiaries base the amount of their liabilities 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 provisions of our insurance policies relating to the type of loss. Our insurance subsidiaries determine the amount of their liabilities 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 unpaid losses and loss expenses.

Our liability 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 bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries' external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries make adjustments they consider appropriate for those changes in their liabilities. Accordingly, our insurance subsidiaries' ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at June 30, 2010. For every 1% change in our estimate of our insurance subsidiaries' liability for unpaid losses and loss expenses, 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. There can be no assurance that the ultimate liability of our insurance subsidiaries will not exceed our insurance subsidiaries' unpaid 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 unpaid 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 liabilities for unpaid losses and loss expenses generally reflect actual payments and the evaluation of information received since the prior reporting date.

Excluding the impact of severe weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic conditions have extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. We may make adjustments in the future to reflect subsequent developments. 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 liabilities for unpaid losses and loss expenses as of June 30, 2010.

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 share any adverse risk development of the pooled business according to their respective participation in the pool. The business

in the pool is homogeneous, and the pooling agreement provides that each company has a percentage share of the entire pool. Since Atlantic States and Donegal Mutual pool substantially all their business and each company shares the results according to its respective 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 Atlantic States and Donegal Mutual.

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, Donegal Mutual and our insurance subsidiaries, operating together as the Donegal Insurance Group, 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 Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group's ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier products compared to standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, because the pool homogenizes the risk characteristics of all business written directly by Donegal Mutual and Atlantic States and each company shares the results according to each company's participation percentage, each company realizes its percentage share of the underwriting results of the pool. Our insurance subsidiaries' unpaid liability for losses and loss expenses by major line of business as of June 30, 2010 and December 31, 2009 consisted of the following:

|   | June 30,<br>2010 | December<br>31,<br>2009 |
|---|------------------|-------------------------|
|   | (in thousands)   |                         |
| Commercial lines:                                   |                  |                         |
| Automobile  | \$ 20,702        | \$ 21,465               |
| Workers compensation                                | 39,443           | 38,092                  |
| Commercial multi-peril                              | 34,156           | 30,640                  |
| Other   | 2,013            | 1,886                   |
| Total commercial lines                              | 96,314           | 92,083                  |
| Personal lines:                                     |                  |                         |
| Automobile  | 71,005           | 70,019                  |
| Homeowners  | 14,933           | 16,312                  |
| Other   | 1,812            | 1,848                   |
| Total personal lines                                | 87,750           | 88,179                  |
| Total commercial and personal lines                 | 184,064          | 180,262                 |
| Plus reinsurance recoverable                        | 92,166           | 83,337                  |
| Total liability for unpaid losses and loss expenses | \$ 276,230       | \$ 263,599              |

We have evaluated the effect on our insurance subsidiaries' unpaid loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables we considered in establishing the loss and loss expense reserves of our insurance subsidiaries. We established the range of reasonably likely changes based on a review of changes in accident year development by line of business and applied those changes 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 the most likely scenario. The following table sets forth the estimated effect on our insurance subsidiaries' unpaid loss and loss expense reserves and our stockholders' equity in the event of reasonably likely changes in the variables we considered in establishing loss and loss expense reserves:

| Percentage Change in Loss and Loss Expense Reserves Net of Reinsurance | Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of June 30, 2010 | Percentage Change in Stockholders Equity as of June 30, 2010(1) | Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2009 | Percentage Change in Stockholders Equity as of December 31, 2009(1) |
|--|--|---|--|---|
|  |  | (dollars in thousands)  |  |   |
| (10.0)%  | \$ 165,658   | 3.1%  | \$ 162,236   | 3.0%  |
| (7.5)  | 170,259  | 2.3   | 166,742  | 2.3   |
| (5.0)  | 174,861  | 1.5   | 171,249  | 1.5   |
| (2.5)  | 179,462  | 0.8   | 175,755  | 0.8   |
| Base   | 184,064  |   | 180,262  |   |
| 2.5  | 188,666  | -0.8  | 184,769  | -0.8  |
| 5.0  | 193,267  | -1.5  | 189,275  | -1.5  |
| 7.5  | 197,869  | -2.3  | 193,782  | -2.3  |
| 10.0   | 202,470  | -3.1  | 198,288  | -3.0  |

(1) Net of income tax effect.

#### 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, when we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations. We individually monitor all investments for other-than-temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in such an unrealized loss position for more than six months, we assume there has been an other-than-temporary decline in value. We held nine equity securities that were in an unrealized loss position at June 30, 2010. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we consider 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 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 security prior to recovery. If 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 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. To determine whether a credit loss has occurred, we compare 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 a credit loss to have occurred. If we consider that a credit loss has 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 the fair value of the investment being significantly below its cost, whether the financial condition of the issuer of a security is deteriorating, the occurrence of industry, company and geographic events that have negatively impacted the value of a security and rating agency downgrades. We determined that no investments with a fair value below cost had declined on an other-than-temporary basis during the first six months of 2010 and 2009, respectively.

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 was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for our fixed maturity and equity investments. 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 the pricing services provide to determine if the estimates obtained are representative of market prices based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. As of June 30, 2010 and December 31, 2009, 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 the pricing services provided as of June 30, 2010 and December 31, 2009, we did not identify any discrepancies and we did not make any adjustments to the fair value estimates the pricing services provided. We classified one equity security as Level 3 as of June 30, 2010, as described in Footnote 9 to the Notes to Consolidated Financial Statements. We utilized a fair value model that incorporated significant other unobservable inputs, such as estimated volatility, to estimate the equity security's fair value. Pursuant to terms of an initial public offering, we are restricted from selling this security for a specified period, and the fair value we determined as of June 30, 2010 reflects this restriction.

#### Policy Acquisition Costs

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and relate primarily to the production of business. We amortize these costs over the period in which our insurance subsidiaries earn the related 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 premiums to be earned, related investment income, losses and loss expenses and certain other costs we expect to incur as our insurance subsidiaries earn the premiums.

#### **Results of Operations Three Months Ended June 30, 2010 Compared to Three Months Ended June 30, 2009**

*Net Premiums Written.* Net premiums written for the three months ended June 30, 2010 were \$102.4 million, an increase of \$8.8 million, or 9.4%, from the \$93.6 million of net premiums written for the comparable period in 2009. Personal lines net premiums written increased \$4.8 million, or 7.4%, for the second quarter of 2010 compared to the comparable period in 2009. The increase was attributable to additional personal lines premiums received from the pooling agreement as a result of Donegal Mutual's affiliation with Southern Mutual, as well as increased writings in our personal automobile and homeowners lines of business. Commercial lines net premiums written increased \$4.0 million, or 13.7%, for the second quarter of 2010 compared to the comparable period in 2009 due to increased writings in our commercial multi-peril and workers' compensation lines of business.

*Net Premiums Earned.* Net premiums earned were \$93.0 million, an increase of \$5.5 million, or 6.3%, compared to \$87.5 million for the second quarter of 2009. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

*Investment Income.* For the three months ended June 30, 2010, our net investment income decreased to \$5.0 million, compared to \$5.3 million for the comparable period one year ago. An increase in our average invested assets from \$635.1 million for the second quarter of 2009 to \$664.9 million for the second quarter of 2010 was offset by a decrease in our annualized average rate of return to 3.0% in 2010, compared to 3.3% in 2009. Our annualized average rate of return on investments decreased primarily due to lower market interest rates over the past year.

*Net Realized Investment Gains.* Net realized investment gains for the second quarter of 2010 were \$2.0 million, compared to \$445,140 for the comparable period in 2009. We did not recognize any impairment losses during the

second quarter of 2010 or 2009.



*Losses and Loss Expenses.* Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the second quarter of 2010 was 73.7%, an increase from our 70.7% loss ratio for the second quarter of 2009. We incurred weather-related losses of approximately \$10 million after reinsurance during the second quarter of 2010, primarily related to a number of wind and hail events in the Mid-Atlantic and Midwestern regions, compared to approximately \$8.0 million during the second quarter of 2009. We incurred fire losses of approximately \$6.1 million during the second quarter of 2010, compared to approximately \$3.5 million during the second quarter of 2009. Our commercial lines loss ratio decreased to 61.1% for the second quarter of 2010, compared to 64.0% for the second quarter of 2009, primarily due to decreases in our commercial automobile and workers' compensation loss ratios. Our personal lines loss ratio increased to 79.6% for the second quarter of 2010, compared to 74.0% for the second quarter of 2009, primarily due to increases in our personal automobile and homeowners loss ratios.

*Underwriting Expenses.* Our expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the second quarters of 2010 and 2009 were 32.6% and 31.0%, respectively. Our expense ratio for both periods reflected decreased expenses incurred for underwriting-based incentive compensation costs as a result of our higher loss ratios.

*Combined Ratio.* Our combined ratio was 106.4% and 101.8% for the three months ended June 30, 2010 and 2009, respectively. Our combined ratio represents the sum of our loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The increase in combined ratio is due to an increase in loss ratio.

*Interest Expense.* Interest expense for the second quarter of 2010 was \$168,935, compared to \$198,467 for the second quarter of 2009. The lower interest expense in the 2010 period reflected a decrease in average interest rates on our subordinated debentures for the second quarter of 2010 compared to the comparable period in 2009.

*Income Taxes.* Income tax expense was \$131,148 for the second quarter of 2010, representing an effective tax rate of 7.0%, compared to \$745,904 for the second quarter of 2009, representing an effective tax rate of 14.5%. Effective tax rates in both periods represented estimates based on projected annual taxable income, with the decrease in 2010 attributable to tax-exempt interest representing a larger proportion of our income before taxes.

*Net Income and Earnings Per Share.* Our net income for the second quarter of 2010 was \$1.7 million, or \$.07 per share of Class A common stock and \$.06 per share of Class B common stock, compared to net income of \$4.4 million, or \$.18 per share of Class A common stock and \$.16 per share of Class B common stock, for the second quarter of 2009. We had 19.9 million Class A shares and 5.6 million Class B shares outstanding for both periods.

### **Results of Operations Six Months Ended June 30, 2010 Compared to Six Months Ended June 30, 2009**

*Net Premiums Written.* Net premiums written for the six months ended June 30, 2010 were \$195.3 million, an increase of \$13.7 million, or 7.6%, from the \$181.6 million of net premiums written for the comparable period in 2009. Personal lines net premiums written increased \$8.4 million, or 6.9%, for the first half of 2010 compared to the comparable period in 2009. The increase was attributable to additional personal lines premiums received from the pooling agreement as a result of Donegal Mutual's affiliation with Southern Mutual, as well as increased writings in our personal automobile and homeowners lines of business. Commercial lines net premiums written increased \$5.3 million, or 8.8%, for the first half of 2010 compared to the comparable period in 2009 due to increased writings in our commercial automobile, commercial multi-peril and workers' compensation lines of business.

*Net Premiums Earned.* Net premiums earned were \$184.4 million, an increase of \$8.5 million, or 4.8%, compared to \$175.9 million for the first half of 2009. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

*Investment Income.* For the six months ended June 30, 2010, our net investment income decreased to \$9.9 million, compared to \$10.6 million for the comparable period one year ago. An increase in our average invested assets from \$631.4 million for the first half of 2009 to \$669.5 million for the first half of 2010 was offset by a decrease in our annualized average rate of return to 3.0% in 2010, compared to

3.4% in 2009. Our annualized average rate of return on investments decreased primarily due to lower market interest rates over the past year.

*Net Realized Investment Gains.* Net realized investment gains for the first half of 2010 were \$2.0 million, compared to \$703,995 for the comparable period in 2009. We did not recognize any impairment losses during the first half of 2010 or 2009.

*Losses and Loss Expenses.* Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the first half of 2010 was 74.0%, an increase from our 72.7% loss ratio for the first half of 2009. We incurred weather-related losses of approximately \$19 million after reinsurance during the first half of 2010, primarily related to a number of wind and hail events in the Mid-Atlantic and Midwestern regions and two major winter storms in the Mid-Atlantic region, compared to approximately \$15.6 million during the first half of 2009. We incurred fire losses of approximately \$14.0 million during the first half of 2010, compared to approximately \$10.5 million during the first half of 2009. Our commercial lines loss ratio increased to 69.5% for the first half of 2010, compared to 65.8% for the first half of 2009, primarily due to increases in our commercial automobile and commercial multi-peril loss ratios. Our personal lines loss ratio increased slightly to 76.3% for the first half of 2010, compared to 76.1% for the first half of 2009, primarily due to increases in our homeowners loss ratios.

*Underwriting Expenses.* Our expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the first half of 2010 and 2009 were 32.0% and 31.0%, respectively. Our expense ratio for both periods reflected decreased expenses incurred for underwriting-based incentive compensation costs as a result of our higher loss ratios.

*Combined Ratio.* Our combined ratio was 106.2% and 103.9% for the six months ended June 30, 2010 and 2009, respectively. Our combined ratio represents the sum of our loss ratio, expense ratio and dividend ratio, which is the ratio of workers' compensation policy dividends incurred to premiums earned. The increase in combined ratio is due to an increase in loss ratio.

*Interest Expense.* Interest expense for the first half of 2010 was \$353,693, compared to \$1.4 million for the first half of 2009. The lower interest expense in the 2010 period reflected a decrease in average interest rates on our subordinated debentures for the first half of 2010 compared to the comparable period in 2009. Interest expense for the first half of 2009 included \$974,000 related to interest and penalties on contested premium tax litigation paid during that period.

*Income Taxes.* Income tax expense was \$171,928 for the first half of 2010, representing an effective tax rate of 8.0%, compared to \$788,355 for the first half of 2009, representing an effective tax rate of 14.7%. Effective tax rates in both periods represented estimates based on projected annual taxable income, with the decrease in 2010 attributable to tax-exempt interest representing a larger proportion of income before taxes.

*Net Income and Earnings Per Share.* Our net income for the first half of 2010 was \$2.0 million, or \$.08 per share of Class A common stock and \$.07 per share of Class B common stock, compared to net income of \$4.6 million, or \$.18 per share of Class A common stock and \$.16 per share of Class B common stock, reported for the first half of 2009. We had 19.9 million Class A shares outstanding for both periods. We had 5.6 million Class B shares outstanding for both periods.

### **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 add to our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement between Donegal Mutual and Atlantic States has historically been cash flow positive because of the consistent underwriting profitability of the 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 have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain significant liquidity in our investment portfolio in the form of readily 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 should an unexpected variation occur in the future. Net cash flows provided by operating activities in the first half of 2010 and 2009 were \$4.3 million and \$7.7 million, respectively, with the change in cash flows due primarily to increased claim payments during the first half of 2010.

In June 2010, we renewed our existing credit agreement with Manufacturers and Traders Trust Company ( M&T ) relating to a \$35.0 million unsecured, revolving line of credit that will expire in June 2013. We may request a one-year extension of the credit agreement as of each anniversary date of the agreement. We may also request an increase in the credit amount in an amount not to exceed \$25.0 million, thereby bringing the line of credit to \$60.0 million. As of June 30, 2010, we had 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 1.75% and 2.25%, depending on our leverage ratio. In addition, we pay a fee of 0.2% per annum on the loan commitment amount regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and the A.M. Best ratings of our insurance subsidiaries. During the six months ended June 30, 2010, we had no borrowings outstanding under the credit agreement, and we were in compliance with all requirements of the credit agreement.

The following table shows our expected payments for significant contractual obligations as of June 30, 2010.

|   | Total      | Less<br>than 1<br>year<br>(in thousands) | 1-3 years | 4-5<br>years | After 5<br>years |
|---|------------|--|-----------|--------------|------------------|
| Net liability for unpaid losses and loss expenses of our insurance subsidiaries | \$ 184,064 | \$ 84,217                                | \$ 83,876 | \$ 7,481     | \$ 8,490         |
| Subordinated debentures   | 15,465     |  |           |              | 15,465           |
| Total contractual obligations   | \$ 199,529 | \$ 84,217                                | \$ 83,876 | \$ 7,481     | \$ 23,955        |

We estimate the date of payment 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 is shown net of reinsurance recoverable on unpaid losses and loss expenses to reflect expected future cash flows related to such liability. Amounts Atlantic States assumes pursuant to the pooling agreement with Donegal Mutual represent a substantial portion of our insurance subsidiaries' gross liability for unpaid losses and loss expenses, and amounts Atlantic States cedes pursuant to the pooling agreement represent a substantial portion of our insurance subsidiaries' reinsurance recoverable on unpaid losses and loss expenses. Cash settlement of Atlantic States' assumed liability from the pool is included in monthly settlements of pooled activity, as we net amounts ceded to and assumed from the pool. Although Donegal Mutual and we do not anticipate any changes in the pool participation levels in the foreseeable future, any such change would be prospective in nature and therefore would not impact the timing of expected payments by Atlantic States for its percentage share of pooled losses occurring in periods prior to the effective date of such change.

We estimate the date of payment for the subordinated debentures based on their contractual maturities. The debentures are redeemable at our option, at par, as discussed in Note 7 - Subordinated Debentures. The 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 June 30, 2010, our annual interest cost associated with the subordinated debentures is approximately \$634,000. For every 1% change in the three-month LIBOR rate, the effect on our annual interest cost would be approximately \$150,000.

On February 23, 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 prices prevailing from time to time in the open market subject to the applicable SEC rules and in privately negotiated transactions. We did not purchase any shares of our

Class A common stock under this program during the three months ended June 30, 2010 and 2009, respectively. We purchased 9,702 and no shares of our Class A common stock under this program during the six months ended June 30, 2010 and 2009, respectively. We have purchased a total of 17,371 shares of our Class A common stock under this program through June 30, 2010.

On July 15, 2010, our board of directors declared quarterly cash dividends of 11.5 cents per share for our Class A common stock and 10.25 cents per share for our Class B common stock, payable August 16, 2010 to stockholders of record as of the close of business on August 2, 2010. There are no regulatory restrictions on our payment of dividends to our stockholders, although there are state law restrictions on the payment of annual dividends greater than 10% of statutory surplus by our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis and require prior approval of the applicable domiciliary insurance regulatory authorities for dividends in excess of 10% of statutory surplus. Our insurance subsidiaries are subject to risk-based capital ( RBC ) requirements. At December 31, 2009, our insurance subsidiaries' capital levels were each substantially above the applicable RBC requirements. At January 1, 2010, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were \$19.0 million from Atlantic States, \$0 from Southern, \$2.8 million from Le Mars, \$3.9 million from Peninsula, and \$584,431 from Sheboygan, all of which remained available at June 30, 2010.

As of June 30, 2010, we had no material commitments for capital expenditures. We anticipate that our pending acquisitions of UNNF and MICO will close in the fourth quarter of 2010. We currently estimate that the cash purchase price of these acquisitions will total approximately \$51 million, which we will derive from our existing internally generated funds, dividends from our insurance subsidiaries and draws under our line of credit.

#### **Equity Price Risk**

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

#### **Credit Risk**

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

Our insurance subsidiaries provide property and casualty insurance coverages through independent insurance agencies. We bill the majority of this business directly to the insured, although a portion of our commercial business is billed through agents to whom our insurance subsidiaries extend credit in the normal course of business.

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

#### **Impact of Inflation**

We establish property and casualty insurance premium rates before we know the amount of unpaid losses and loss 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.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

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

Our investment mix has shifted slightly due to a shift from lower-yielding short-term investments to fixed maturity investments during 2010. We have maintained approximately the same duration of our investment portfolio to our liabilities from December 31, 2009 to June 30, 2010.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2009 through June 30, 2010.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

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

**Changes in Internal Control Over Financial Reporting**

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

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

All statements contained in this report that are not historic facts are based on current expectations. Such statements are forward-looking in nature (as defined in the Private Securities Litigation Reform Act of 1995) and necessarily involve risks and uncertainties. Actual results could vary materially. The factors that could cause actual results to vary materially include, but are not limited to, our ability to maintain profitable operations, the adequacy of our reserves for unpaid losses and loss adjustment expenses, business and economic conditions in the areas in which we operate, conditions resulting from the ongoing recession in the United States, severe weather events, competition from various insurance and non-insurance businesses, terrorism, the availability and cost of reinsurance, legal and judicial developments, changes in regulatory requirements and other risks that we describe from time to time in our filings with the SEC. We disclaim any obligation to update such statements or to announce publicly the results of any revisions that may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

**Item 4T. Controls and Procedures.**

Not applicable.

**Part II. Other Information**

**Item 1. Legal Proceedings.**

None.

**Item 1A. Risk Factors.**

Our business, results of operations and financial condition, and, therefore, the value of our Class A common stock and Class B common stock, are subject to a number of risks. For a description of certain risks, we refer to Risk Factors in our 2009 Annual Report on Form 10-K filed with the SEC on March 11, 2010. There have been no material changes in the risk factors disclosed in that Form 10-K Report during the six months ended June 30, 2010.

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

None.

**Item 3. Defaults upon Senior Securities.**

None.

**Item 4. Removed and Reserved.**

**Item 5. Other Information.**

None.



**Item 6. Exhibits.**

| Exhibit No.  | Description   |
|--------------|---|
| Exhibit 31.1 | Certification of Chief Executive Officer  |
| Exhibit 31.2 | Certification of Chief Financial Officer  |
| Exhibit 32.1 | Statement of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code |
| Exhibit 32.2 | Statement of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 of Title 18 of the United States Code |

**Signatures**

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

**DONEGAL GROUP INC.**

August 9, 2010

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

August 9, 2010

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

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