

# DUANE MORRIS

FIRM and AFFILIATE OFFICES

FREDERICK W. DREHER  
DIRECT DIAL: 215.979.1234  
PERSONAL FAX: 215.979.1213  
E-MAIL: [fwdreher@duanemorris.com](mailto:fwdreher@duanemorris.com)

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March 19, 2007

## BY HAND DELIVERY AND E-MAIL

Peter Medley  
Insurance Examiner Supervisor  
Bureau of Financial Analysis and Examinations  
State of Wisconsin  
Office of the Commissioner of Insurance  
125 South Webster Street  
Madison, Wisconsin 53707

Re: Form A Filing

Dear Mr. Medley:

The purpose of this letter is to respond, on behalf of Donegal Mutual Insurance Company ("Donegal Mutual"), to the comments contained in your February 16, 2007 letter on behalf of the Office of the Commissioner of Insurance of the State of Wisconsin ("OCI") to Donald H. Nikolaus, the President and Chief Executive Officer of Donegal Mutual.

For convenience of reference, we have included each of the numbered comments in your letter followed by Donegal Mutual's response to the comment. Capitalized terms used in this letter but not defined herein shall have the meanings ascribed to them in the Form A filing by Donegal Mutual regarding the acquisition of control of Sheboygan Falls Mutual Insurance Company ("SFMIC") dated December 28, 2006.

We are also pleased to enclose a copy of Donegal Mutual's annual statement for 2006.

Donegal Mutual's specific responses are as follows:

*Form A filing*

1. On page 5 of the Form A filing, regarding Delaware Mutual, it states that the demutualization occurred in 1999 and the acquisition of stock by DGI occurred in 1995. Is there an error in the dates?

Yes. There is an inadvertent error in the dates. The demutualization of Delaware Mutual Insurance Company occurred in 1994 rather than in 1999.

2. Please provide a summary of the terms of the demutualization of LeMars Mutual, including but not limited to the financial assets (cash, stock, etc.) provided to its policyholders, and how Donegal obtained control of Le Mars' common stock.

In June 2002, with the approval of the Iowa Division of Insurance, Donegal Mutual purchased a \$4.0 million surplus note from Le Mars Mutual Insurance Company of Iowa ("Le Mars"). As part of that transaction, Donegal Mutual acquired control of Le Mars through the appointment of five Donegal Mutual designees to Le Mars' Board of Directors.

Donegal Mutual also entered into a Services Agreement with Le Mars whereby Donegal Mutual made available to Le Mars Donegal Mutual's experience in assisting mutual insurance companies in restructuring their insurance business and operations in order to improve underwriting results and strengthening their financial condition.

The principal steps leading to the demutualization of Le Mars were as follows:

- In June 2003, Le Mars' Board of Directors authorized the preparation of a plan of conversion;
- In June 2003, Le Mars appointed a Demutualization Committee of its Board of Directors that consisted solely of the four directors who had no affiliation with Donegal Mutual or DGI;
- In June 2003, Le Mars retained independent Iowa counsel;
- In June 2003, Le Mars engaged the independent investment banking firm of Legg Mason Wood Walker, Incorporated to determine the fair economic value of Le Mars and the consideration to be paid to the policyholders of Le Mars;
- In July 2003, Le Mars retained an independent real estate appraisal firm to appraise the value of Le Mars' home office;

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- In August 2003, after receiving the opinion of its independent investment banker, independent appraiser and independent counsel, the Demutualization Committee recommended that the Board of Directors of Le Mars adopt a plan of conversion;
- On August 11, 2003, the Board of Directors of Le Mars adopted a plan of conversion. The plan of conversion provided for two forms of cash consideration to be paid to the policyholders of Le Mars as described below;
- On October 6, 2003, at a special meeting of the policyholders of Le Mars, the policyholders of Le Mars approved the plan of conversion;
- On October 7, 2003, the Insurance Commissioner of the State of Iowa held a public hearing on the plan of conversion; and
- On November 6, 2003, the Insurance Commissioner of the State of Iowa issued an order declaring that the plan of conversion was fair and equitable to Le Mars and fair and equitable to the policyholders of Le Mars.

The demutualization of Le Mars resulted in the payment of two forms of cash consideration to the policyholders of Le Mars as follows:

- Each policyholder of Le Mars on August 11, 2003, the date the plan of conversion was adopted by Le Mars' Board of Directors, received a one-time cash payment of \$15.00 as consideration for the termination of the voting rights of each such policyholder; and
- Each policyholder of Le Mars at any time during the three-year period ended August 10, 2003, the day prior to the date the plan of conversion was adopted by Le Mars' Board of Directors, received a one-time aggregate cash payment equal to such policyholder's equitable interest in the fair economic value of Le Mars. This amount was calculated by subtracting Le Mars' costs and expenses in effecting the plan of conversion and the payments made to extinguish voting rights from \$8.2 million, an amount determined by Le Mars' Board of Directors to be a fair market value for Le Mars. The amount of the cash payment to each policyholder was determined by multiplying the aggregate cash payment by the ratio determined by dividing net earned premiums properly and timely paid by a policyholder to Le Mars during the three-year period by the total net earned premiums Le Mars received from all policyholders during that three-year period.

To effectuate the demutualization, Donegal Mutual transferred the outstanding \$4.0 million surplus note, plus accrued and unpaid interest thereon, to DGI immediately prior to the demutualization. As permitted by Iowa law and the terms of the surplus note, DGI exchanged the surplus note, the accrued but unpaid interest thereon and a capital contribution for shares of common stock of the successor stock insurance company into which Le Mars was converted. The amount of the capital contribution was such that Le Mars' surplus after conversion to a stock insurance company and after the one-time cash payments to Le Mars' policyholders was the same as Le Mars' surplus on the date its Board of Directors adopted the plan of conversion. As a result of the demutualization, Le Mars became a stock insurance company named Le Mars Insurance Company and a wholly owned subsidiary of DGI.

Under Section 515G.3 of the Iowa Code, any consideration payable to a policyholder in exchange for the extinguishment of the policyholder's voting rights and any consideration payable because of the policyholder's equitable interest in the fair economic value of an insurance company upon its demutualization may be made in securities or other consideration or both. The sole consideration payable in connection with the demutualization of Le Mars was cash. Neither stock nor any other property of Le Mars Insurance Company, the converted entity, nor of DGI was provided to policyholders of Le Mars. The Iowa Commissioner of Insurance determined that a cash distribution maximized the amount each Le Mars policyholder would actually receive and that the administrative costs of a stock distribution would unreasonably reduce the amount of value each Le Mars policyholder would actually receive.

A copy of the September 2, 2003 Information Statement provided to the policyholders of Le Mars in connection with the Special Meeting of Members to approve the plan of conversion is included as Appendix 1 to this letter.

3. *Please explain how the parties determined that \$3.5 Million is the appropriate amount for the proposed Contribution Note; which specific financial ratios, marketing plans, rating agency views, etc., were considered in determining the amount.*

Donegal Mutual arrived at the proposed \$3.5 million contribution note amount in consultation with SFMIC in consideration of SFMIC's current financial condition and based upon Donegal Mutual's experience gained in similar past affiliations with modest-sized mutual companies. Based upon SFMIC's reported statutory surplus of approximately \$6.9 million as of December 31, 2006, the proposed contribution note proceeds of \$3.5 million would provide SFMIC with surplus in excess of \$10 million, which Donegal Mutual and SFMIC view as a required threshold to support SFMIC's current plans for growth, attracting new agency appointments and expansion of product lines. Both Donegal Mutual and

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SFMIC believe the amount of the contribution note is appropriate. Donegal Mutual further believes that \$3.5 million represents a sizable investment relative to the size of SFMIC and would indicate a strong level of commitment to SFMIC on the part of Donegal Mutual. Finally, Donegal Mutual and SFMIC believe that SFMIC's increased surplus level would position SFMIC for favorable consideration by A.M. Best in the potential assignment of Donegal Mutual's group rating of A (Excellent).

4. *Donegal is frank in disclosing its long-term plan to demutualize SFMIC in accordance with s.611.76, Wis. Stat., and that DGI would seek to acquire all of the stock of SFMIC after the demutualization. Acknowledging that this hypothetical transaction is not the subject of the current filing, please explain how a plan would comply with the statutes. Under existing s. 611.76, all of the stock of a converted SFMIC would be issued to persons who were its policyholders in the previous 5 years, at a defined price per share (say, \$10). DGI would seek to acquire all of the common stock from those persons, which will likely include some who do not wish to sell except at a profit. How could DGI make an offer to buy at a higher price per share (say \$11) than SFMIC's board approved as being fair to the policyholders, since DGI has common management with SFMIC? Section (4m) provides an alternative process, which would allow policyholders to receive the value in any form including securities of another entity or cash; however that section only applies if grounds exist for rehabilitation or liquidation; does Donegal intend to manage SFMIC into a condition where it is financially hazardous?*

Both Donegal Mutual and SFMIC believe that SFMIC's long-term growth and profitability are dependent on SFMIC's ability to access permanent equity capital in order to maintain surplus adequacy. On the five prior occasions in which Donegal Mutual has made surplus note investments in a mutual company, the mutual company has ultimately demutualized as the methodology by which it obtained permanent access to equity capital. Therefore, Donegal Mutual's current intent is to demutualize SFMIC in the future, although Donegal Mutual has not devoted significant thought to this topic because, as your letter indicates, it is hypothetical. S. 611.76(1)(c), Wis. Stat., permits a plan of demutualization to be coupled with a plan of acquisition or a plan of merger. Alternatively, Wisconsin law would permit the merger of SFMIC with Donegal Mutual. In addition, a newly-formed Donegal Mutual Wisconsin-domiciled stock insurance company subsidiary could purchase all of the assets and assume all of the liabilities of SFMIC, or a mutual holding company structure could be put in place for SFMIC.

Donegal Mutual therefore believes that Wisconsin law could permit a number of different processes by which Donegal Mutual or DGI could acquire SFMIC. Each of these alternatives would require approval from SFMIC's board of directors, its policyholders or shareholders and OCI.

We encourage you to take a closer look at Donegal Mutual's track record. As we discussed in our recent meeting with you and your colleagues, Donegal Mutual's business model is to identify small-to-mid-sized mutual companies which fit its geographic strategy and that would benefit from access to additional capital and greater economies of scale in information technology and other "back office" support functions. After affiliating with such companies, Donegal Mutual works with the board of directors and company management to strengthen and grow these companies, which benefits not only Donegal Mutual and DGI's stockholders, but also benefits the policyholders, employees and home communities of the companies Donegal Mutual demutualizes or acquires. You do not have to take our word for this--an examination of our history with such companies as Le Mars, and a conversation with the state insurance administrators in the domiciliary states of such companies which include Maryland, Ohio, Delaware and New York in addition to Iowa, will show that Donegal Mutual's actions have been consistent with its stated intentions.

Donegal Mutual does not believe it would be productive at this point in time for any of us to focus to any significant extent on future changes in the structure of SFMIC.

5. *Does Donegal believe that the proposed Reinsurance and Retrocession Agreement with SFMIC would make Donegal a "policyholder" of SFMIC for the purposes of s. 611.76, Wis. Stat.? OCI would like to receive a statement by Donegal and by SFMIC that this proposed reinsurance agreement does not give Donegal any rights as a "policyholder" of SFMIC for the purposes of s. 611.76, Wis. Stat., and that Donegal would not assert any such rights.*

Donegal Mutual does not believe it is appropriate for it to answer the legal question whether the proposed Reinsurance and Retrocession Agreement with SFMIC would make Donegal Mutual a "policyholder" of SFMIC for the purposes of s. 611.76, Wis. Stat. However, Donegal Mutual includes as Appendix 2 to this letter a draft of a letter from Donegal Mutual stating that Donegal Mutual will not assert any rights as a "policyholder" of SFMIC for the purposes of s. 611.76, Wis. Stat.

6. *Has Donegal identified any methods of satisfying rating agency requirements to pass Donegal's financial ratings to its affiliated insurers other than the proposed Reinsurance and Retrocession agreement? It seems unusual that a rating agency would require the execution of a purported reinsurance agreement, which does not transfer risk and should not be reported as reinsurance, as a condition for issuing a rating.*

Although there are other methods to satisfy the requirements of A.M. Best & Company other than the retrocessional reinsurance agreements, Donegal Mutual, as well as other companies, have utilized retrocessional reinsurance agreements because retrocessional reinsurance agreements are expressly permitted by A.M. Best & Company. Donegal Mutual

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proposed the retrocessional reinsurance method in order to assist SFMIC in pursuing a rating increase with A.M. Best & Company. We enclose as Appendix 3 to this letter a publication of A.M. Best & Company titled "Rating Members of Insurance Groups". We make particular reference to "Reinsurance Affiliations" on page 6 of that publication. That publication also describes alternative methodologies, but all of the alternatives would be significantly more difficult for Donegal Mutual to implement.

We acknowledge that the retrocessional reinsurance agreements do not transfer risk under NAIC accounting standards. However, the retrocessional reinsurance agreements are legally binding contractual obligations and, in the event of SFMIC's insolvency, Donegal Mutual would have assumed considerable risk. The retrocessional reinsurance agreements are in a form provided by A.M. Best.

#### ***Contribution Note Purchase Agreement***

7. *Which CPA firm would audit SFMIC from the time of Closing to the time, if ever, that DGI purchased the shares of a converted SFMIC?*

Donegal Mutual currently anticipates that KPMG, LLP would be engaged to audit SFMIC beginning with the year ending December 31, 2007. KPMG, LLP currently audits Donegal Mutual and DGI and its affiliates and has a national reputation. Because DGI is subject to the reporting requirements of the Securities Exchange Act of 1934, it is important to Donegal Mutual that the financial statements of its affiliates be audited by firms that are registered with the Public Company Accounting Oversight Board.

8. *There are numerous Schedules referred to in the CNPA, however they do not appear to be included with the CNPA; please provide them. These include: Schedule 3.4(C), 3.4(E), 3.10, 3.11(A), 3.12, 3.18, and 3.19*

A copy of all of the schedules to the CNPA is included as Appendix 4 to this letter.

9. *Section 5.4 is titled "Maintain Sheboygan Falls as a Going Concern". It says "Except as otherwise specifically provided herein, Sheboygan Falls shall conduct its business in accordance with past practices and use its best efforts to maintain its business organization intact, ...." Please explain what "except as otherwise specifically provided herein" refers to, specifically what are those exceptions?*

Section 5.4 obligates SFMIC, among other things, to conduct its business in accordance with past practices, to use its best efforts to maintain its business organization intact, keep available the services of its officers, employees and agents and preserve its good will. Section 5.4 also requires SFMIC to supply various reports to Donegal Mutual, and confer with

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Donegal Mutual on various topics. The purpose of the language you have noted is to enable SFMIC to engage in certain activities provided for elsewhere in the CNPA without causing SFMIC to be in breach of Section 5.4 of the CNPA. Such exceptions include the amendment of SFMIC's by-laws, the employment agreements between SFMIC and certain of its officers, the appointment of the Donegal Mutual designees to the SFMIC board, and SFMIC's entry into the services and technology licensing agreements with Donegal Mutual.

10. *Section 5.9 makes certain representations regarding the composition of SFMIC's future board of directors, a requirement for a supermajority vote to close SFMIC's offices, etc., however the proposed Bylaws do not include any language that carries out these representations. There are further questions on this in the section on the proposed Bylaws.*

Donegal Mutual interprets your comment as a question relating to the enforceability of these provisions in a context where Donegal Mutual's designees will constitute a majority of the board of directors of SFMIC. This question would not be remedied by By-law provisions because SFMIC's board of directors would be the party to enforce the By-laws.

Donegal Mutual has effected five surplus note transactions in the past few years. Each of those transactions involved similar covenants. In each of these instances, each and every covenant was performed in accordance with its terms.

Donegal Mutual's directors who will serve on SFMIC's board of directors are well aware of their fiduciary responsibilities to the policyholders of SFMIC and their obligation to act in the best interests of those policyholders. Donegal Mutual's past record and its excellent regulatory reputation are a sound basis on which SFMIC can justifiably rely for enforcement of these provisions.

11. *Section 5.9(c) refers to a level of employment at SFMIC commensurate with the Wisconsin premium volume of SFMIC and DMIC. However, the marketing plans, projected volume, products and lines of business, etc., of the companies are not very clear. Please provide a marketing plan for Wisconsin for SFMIC, DMIC, and any other Donegal affiliates that are licensed in Wisconsin.*

Donegal Mutual intends to write business in Wisconsin that is different from the business SFMIC is currently writing, such as commercial multi-peril, commercial auto and workers' compensation. These different lines of business will result in a natural demarcation of which company does what business. Donegal Mutual's plan is to write \$400,000 of commercial multi-peril and \$100,000 of workers' compensation in Wisconsin in 2008 and \$750,000 of commercial multi-peril and \$250,000 of workers' compensation in Wisconsin in

2009. Although Le Mars is admitted in Wisconsin, it has no current plans to conduct business in Wisconsin.

SFMIC's expectation is that its premium volume will increase by reason of its affiliation with Donegal Mutual because SFMIC will be more competitive through product segmentation and better capitalization and will provide a more attractive company profile to potential quality agency appointments in Wisconsin.

12. *Section 5.9 (f)(i) states that for as long as the Services Agreement would be in effect, SFMIC will be "a" major writing company in Wisconsin for the Donegal group. Why does this not state "the" major writing company? Please refer to the marketing plan requested above in your response.*

The language used is precise for a purpose. Donegal Mutual could in the future acquire other carriers admitted in Wisconsin that are significantly larger than SFMIC. Donegal Mutual itself could become such a carrier in Wisconsin. To provide perspective, SFMIC had written premium of \$10.0 million in 2006, and the Donegal Insurance Group had written premium of \$433 million in 2006. Donegal Mutual's marketing plan for Wisconsin reflects written premium of \$500,000 in 2008 and \$1.0 million in 2009 that would complement the writing of SFMIC. During its negotiations with SFMIC, Donegal Mutual was clear that it would not agree to any provision that could be interpreted to limit Donegal Mutual's ability to write premiums in Wisconsin in the future.

13. *Section 5.9(f)(iii) refers to SFMIC "offering an expanded line of personal and commercial coverages". Please explain what products are under consideration.*

SFMIC's personal lines business will expand as a result of the product segmentation and predictive underwriting model that will become available through WritePro. SFMIC also expects to expand its commercial lines modestly through WriteBiz. SFMIC is primarily a personal lines company, and Donegal Mutual does not believe that it would be prudent to expand SFMIC's commercial lines in other than small mercantile and service classes of business.

14. *Section 5.9(f)(iv) says "the current book of business" written by SFMIC will be retained by it. How is this term defined? For example, if an existing SFMIC policyholder buys a new building or vehicle, would that new policy be considered "new business" or part of "the current book of business"? If SFMIC appoints a new agent after the date of Closing, would that agent's business be considered "the current book of business"? If an SFMIC agent uses the Donegal WritePro or WriteBiz systems to write new or renewal business, would those policies be considered "the current book of business"? If an existing or new SFMIC agent sells a policy, of the kind and size that SFMIC*

*currently sells, to a new policyholder in that agent's service area in the normal course of business, would this be considered part of SFMIC's "current book of business", and would the policy be written on SFMIC paper or on DMIC paper? Also, we wish to point out that under s. 611.78, Wis. Stat., and holding company regulations, SFMIC cannot transfer any business to affiliates without prior regulatory approval.*

The intent of this language from Donegal Mutual's perspective is that it refers to the policyholders of SFMIC on the date of the affiliation, and any policies renewed by those policyholders after the date of affiliation. The language is intended to exclude SFMIC policyholders who first become SFMIC policyholders after the date of the affiliation.

Donegal Mutual intends to focus on commercial lines in Wisconsin and personal lines products that are complimentary to, but not the same as, the products offered by SFMIC. Donegal Mutual has no intention of transferring SFMIC's business to itself.

Donegal Mutual is aware of the Wisconsin law relating to transactions between an insurance company and affiliated parties.

15. *Section 5.9(h)(i) and (ii) discuss a proposed cost allocation process between SFMIC and Donegal for certain IT costs. Do the parties intend to write a formal cost allocation agreement and submit it for regulatory approval under holding company regulations subsequent to the Closing?*

Donegal Mutual believes that Appendices B and E to the CNPA are formal cost-allocation agreements. One of the principal purposes of the affiliation is to enable SFMIC to assure its ability to survive for the indefinite future. A key element is enabling SFMIC to do so is SFMIC's ability to access Donegal Mutual's technology platform as soon as the affiliation is consummated. The IT costs would be allocated as provided in the Services Agreement which was filed as Appendix B to the CNPA and in the Technology License Agreement filed as Appendix E to the CNPA. Donegal Mutual therefore requests that OCI approve the Services Agreement and the Technology License Agreement as formal cost-allocation agreements that are part of the Form A application.

16. *Section 5.11 establishes negative covenants of SFMIC in the event that Donegal designees shall not be a majority of SFMIC's board. Section (d) states that SFMIC shall not prepay any indebtedness unless after the prepayment SFMIC has surplus, exclusive of the then-outstanding balance of the Contribution Note, no less than 3 times the balance of the Note. (1) Assuming that the balance of the Contribution Note was \$3.5 Million, would this mean that SFMIC would need to have \$10.5 Million of surplus separate from the Note balance before SFMIC could prepay any indebtedness? (2) Why is that 3:1 ratio chosen as an apparent indicator of SFMIC's financial strength or ability to afford to pay other debt? We observe that SFMIC would not meet that 3:1 requirement at the date of*

*issuance of the Contribution Note, so does this indicate that the \$3.5 Million Contribution Note is too large an amount for SFMIC to prudently issue?*

Donegal Mutual's intent is that the word "indebtedness" in Section 5.11(d) refers to bank debt, or funded debt, and that it does not refer to trade payables in the ordinary course of business. With that clarification, the answer to your first question is yes. The plain purpose of Section 5.11(d) is to protect the rights of Donegal Mutual as the holder of a contribution note of SFMIC by restricting certain actions that SFMIC can take that could otherwise have the effect of weakening Donegal Mutual's position as a creditor by allowing another institutional creditor to obtain a preference over Donegal Mutual. The 3:1 ratio is not indicative of SFMIC's financial capacity to issue the surplus note, but rather Donegal Mutual's comfort zone on when SFMIC should be permitted to pay other creditors while the contribution note remains outstanding.

17. *Are there any covenants that apply to Donegal?*

Yes. There are covenants in Sections 5.1(b), 5.2, 5.3(b), 5.6, 5.7 and 5.9 that apply to Donegal Mutual. Because Donegal Mutual is in effect the investor in the contemplated transaction, there are no covenants that directly affect the manner in which Donegal Mutual conducts its business because SFMIC is not investing in Donegal Mutual's business.

#### ***Contribution Note***

*OCI provided a copy of a glossary contribution note for this transaction. Donegal has made numerous changes to the glossary note, contrary to the glossary note's intent and purpose. The following changes, at a minimum, must be made:*

We have been advised by Donegal Mutual's Wisconsin counsel that OCI has not, in the past, required strict adherence to the "glossary" form of contribution note as provided to Donegal Mutual. We understand that Section 611.33 (2)(b)4 of the Wisconsin Statutes requires the Commissioner to make a finding that the terms of the note "are not prejudicial to policyholders" of SFMIC; however, Donegal Mutual does not understand how your comments about the form of contribution note relate to this standard. Repayment of principal and interest on the proposed contribution note is clearly made subject to OCI approval. Further, Donegal Mutual has accepted, verbatim, the lengthy provisions of the OCI glossary form of contribution note which provide for the interests of Donegal Mutual to be subordinated to the claims of all policyholders, and the other subordination provisions found in paragraph 3 of the contribution note. The parties should not be prohibited from inserting other provisions in the contribution note which accurately reflect the commercial terms of the proposed transaction and do not detract from the protection provided to the

policyholders of SFMIC by the aforementioned provisions. Donegal Mutual's specific responses to your contribution note comments follow.

18. *Preamble, par. 2 - delete references to CNPA and NPA, and delete reference to terms being defined in the CNPA;*

The references to the CNPA and the defined terms are in Donegal Mutual's experience commonly accepted ways of drafting surplus notes. Donegal Mutual's Wisconsin counsel has advised it that comparable terminology has, to their knowledge, been used in contribution notes approved by OCI for issuance by Wisconsin companies. The paragraph simply adds context to the contribution note which protects the interests of both parties. Donegal Mutual requests that you reconsider this comment.

19. *Preamble, par. 3 - delete reference to the NPA;*

This paragraph protects the interests of SFMIC and its policyholders. Whether or not the contribution note specifically mentions the CNPA, it is obviously issued as part of the transactions embodied in the CNPA. In Donegal Mutual's view, OCI should not only not object to the provision, but should require it.

20. *Preamble, par 4. - delete entire paragraph (".....mandatory and voluntary repayment .....");*

Donegal Mutual's response is the same as its response to comment 18. Donegal Mutual requests that you reconsider this comment.

21. *par. 1.(a) Please explain why there is a due date in the proposal, as there is not a due date in the OCI glossary note;*

In Donegal Mutual's opinion, a due date is necessary so that SFMIC has an obligation to repay the note if it obtains OCI approval to do so. Without a due date, Donegal Mutual would have no legal ability to seek repayment of the contribution note, ever. To the knowledge of Donegal Mutual's Wisconsin counsel, OCI has routinely approved the issuance of contribution notes by Wisconsin companies that include due dates or maturity dates.

22. *par. 1 (c) - please delete this paragraph, as it is not in the OCI glossary note;*

Donegal Mutual believes that any note needs to have an applications of payments provision so the parties understand whether a payment is interest, principal or a combination of both or a prepayment. This provision is in no way prejudicial to SFMIC's policyholders. Donegal Mutual requests that you reconsider this comment.

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23. *par. 2 - The first three sentences are acceptable, however the fourth sentence must be deleted, as failure to pay interest is properly addressed by section 3(b) following;*

Donegal Mutual believes that paragraph 2 covers matters, such as the fact that unpaid interest is cumulative, that are not protected by the language of Section 3(b). Donegal Mutual therefore requests that you reconsider this comment.

24. *par. 3 (c) - The first two sentences are acceptable, however beginning with the third sentence the remainder of the paragraph must be deleted as they are not in OCI's glossary note language;*

In purchasing the contribution note, Donegal Mutual is subordinating its payment rights to the policyholders of SFMIC, but needs to protect its ultimate right to repayment if all other conditions to payment are met. We request that you reconsider this comment to permit the inclusion of what Donegal Mutual believes is customary subordination language.

25. *par. 3(e) - please delete this section, as it is not in the OCI glossary note;*

Donegal Mutual believes it is entitled to an accurate statement to whom the surplus note is subordinated. Donegal Mutual should not be placed in a position where it is automatically subordinated to any other holders of surplus notes issued by SFMIC or distributions to any eventual equity owners of SFMIC. Donegal Mutual's Wisconsin counsel has advised it that OCI has previously approved the issuance of contribution notes by Wisconsin companies that contain this provision. Donegal Mutual requests that you reconsider this comment.

26. *par. 3(f) - please delete reference to the NPA in this section;*

Since this provision was included in OCI's glossary form of note, we assume OCI believes it is important to protect SFMIC's officers and directors from personal liability. Such liability could arise under either the contribution note or the CNPA. The inclusion of this reference in no way prejudices the interests of SFMIC's policyholders; if anything, it adds to the protections arising under the OCI form language. Donegal Mutual requests that you reconsider this comment.

27. *par. 3(g) - please delete references to the NPA in this section;*

Donegal Mutual believes it is inconsistent to allow such a provision in the contribution note and not to allow it as applied to the CNPA. Again, the inclusion of this provision in no way prejudices the interests of SFMIC's policyholders. Donegal Mutual requests that you reconsider this comment.

28. *par. (4) - please explain why Donegal feels this language is needed; it is not in the OCI glossary and should be deleted from the agreement;*

Donegal Mutual believes that it is a legitimate right of a creditor, whether or not subordinated and whether or not regulatory approval for payment is required, to specify the place of payment of principal and interest on a debt. Donegal Mutual believes the inclusion of such a provision is entirely reasonable and in no way prejudicial to the interests of SFMIC's policyholders. Donegal Mutual requests that you reconsider this comment.

29. *par. (5) - this language is not in the OCI glossary agreement and should be deleted;*

In our experience, all debt obligations, even those that are subordinated and whether or not regulatory approval is required for payment, contain provisions regarding events of default. Otherwise, a creditor would never have to honor its obligations. SFMIC could have \$100 million of surplus, OCI could approve repayment of the contribution note and SFMIC could then refuse to pay. In such an event, Donegal Mutual should be entitled to declare an event of default and enforce repayment. The ability of Donegal Mutual to do so is not prejudicial to the interests of SFMIC's policyholders because OCI would already have approved the repayment. Donegal Mutual requests that you reconsider this comment.

30. *par. (6) - this language is not in the OCI glossary agreement and should be deleted;*

In our experience, all debt obligations provide for remedies if a debtor defaults in its obligations. If SFMIC were to refuse to repay the surplus note notwithstanding OCI approval, it is reasonable for Donegal Mutual to be able to enforce its rights legally and to be able to seek to enforce SFMIC's obligations to it. A note that does not provide for remedies is commercially unreasonable. Donegal Mutual requests that you reconsider this comment. These remedies are expressly made subject to prior OCI approval and other limitations set forth in Section 3 so, again, these provisions are not prejudicial to the interests of SFMIC's policyholders.

31. *par. (7) - this language is not in the OCI glossary agreement and should be deleted.*

Donegal Mutual will remove this provision from the contribution note, but would still envision applying outstanding principal and interest on the contribution note to the purchase price due from Donegal Mutual to SFMIC in any further restructuring of the ownership of SFMIC, subject, of course, to further approval of OCI pursuant to Wisconsin law.

32. *The proposed agreement did not include the paragraph 1. in OCI's glossary agreement, please add that paragraph.*

Donegal Mutual's Wisconsin counsel has advised it that OCI has approved the issuance of contribution notes by Wisconsin companies without the inclusion of this paragraph. Section 1 of the OCI glossary note does not accurately reflect the standard set by the Wisconsin legislature for OCI approval of the repayment of principal or interest on a contribution note. This paragraph is overly restrictive in that it would deprive Donegal Mutual of its right to repayment even if OCI makes a finding that the statutory test for approval of a repayment that "all financial requirements of the issuer to do the insurance business it is then doing will continue to be satisfied after payment and if the interests of its insureds and the public are not endangered" have been met. Donegal Mutual requests that you reconsider this comment.

33. *Please explain why Donegal felt it was necessary to include references to the CNPA and/or NPA in this agreement.*

The contribution note is being delivered to Donegal Mutual as partial consideration in a larger transaction involving a variety of rights and obligations between the parties. It is customary and appropriate to reference this context in the body of the note. Again, Wisconsin counsel has advised Donegal Mutual that OCI has approved the issuance of contribution notes by Wisconsin companies which include such references to the contextual transaction documents.

34. *Please explain how and why the proposed paragraph (7), which would appear to authorize Donegal to convert its surplus note balance receivable to shares in SFMIC, is consistent with Wisconsin statutes.*

The proposed paragraph (7) was expressly made subject to the requirements of Wisconsin law. Section 611.76(1)(c) of the Wisconsin Statutes expressly envisions the possibility of a two-part transaction in which a conversion of a mutual company to stock form could be coupled with a plan of acquisition or merger. In such event, the parties could agree that any amounts due under the contribution note would be applied to any consideration due from Donegal Mutual to SFMIC in such transaction, subject to receipt of the necessary OCI and policyholder approval. Such a provision is something we would expect to discuss with OCI if and when Donegal Mutual determines to pursue a demutualization. For the time being, Donegal Mutual has agreed to remove this provision from the contribution note.

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***Biographical Information***

35. *We observed that Mr. Nikolaus will reach the age of 65 this year. Does Donegal have any age limitations for the position of Chief Executive Officer? Does Mr. Nikolaus plan to retire in the next three years?*

Neither Donegal Mutual nor DGI have any age limitation for their executive officers, and are careful not to engage in any activity that could be construed as age discrimination. We note for the record that the average age of the five senior executive officers of Donegal Mutual is 53. Mr. Nikolaus has no plans to retire in the next three years.

36. *We observed that two Donegal directors are over age 70, and four additional directors will be over age 60 during 2007. Does Donegal have any age limitations for directors? Do any directors plan to retire from their directorships in the next three years?*

Neither Donegal Mutual nor DGI have any age limitations for directors. To the knowledge of Donegal Mutual and DGI, none of their respective directors plans to retire in the next three years. Neither Donegal Mutual nor DGI believe that age should be the sole determinant of the ability of a director to discharge his duties as a director properly. However, both Donegal Mutual and DGI periodically reassess the composition of their respective boards of directors and both companies have recently appointed or elected directors with lower age profiles. Jon M. Mahan (age 37) and S. Trezevant Moore (age 53) joined DGI's board in 2006. In 2006, Scott A. Berlucchi (age 49), Cyril J. Greenya (age 61) and Dennis M. Bixenman (age 59) joined the board of directors of Donegal Mutual.

37. *Please provide a chart or table showing for each Donegal nominee director and officer all of the other affiliated entities for which the person is a director and/or officer, including the person's length of service with that affiliated entity.*

The requested chart is included as Appendix 5 to this letter.

38. *How long has Mr. Bixenman been associated with LeMars, and in what positions? Was he involved with LeMars during the time that it became a financially troubled entity, and if so, what were his positions with the company during that time?*

Mr. Bixenman has served as a director of Le Mars from April 28, 1987 to December 31, 2003 when Le Mars demutualized, and has served as a director of its successor from 2004 to the present. Mr. Bixenman served as Le Mars' Chairman of the Board from April 25, 1995 until Le Mars' affiliation with Donegal Mutual in June 2002. Mr. Bixenman provided the leadership that caused Le Mars to recognize its deteriorating financial condition and to seek an affiliation with a larger, well-capitalized mutual insurance company that had a record of

achieving underwriting profitability in order to successfully resolve its financial difficulties without formal intervention by the Iowa Division of Insurance. Mr. Bixenman has never served as an executive officer of Le Mars.

*Services Agreement*

39. *Will any current Donegal employees or officers be elected to officer positions at SFMIC?*

Following the consummation of the affiliation, the current executive officers of SFMIC will remain in place as is evidenced by the employment agreements included as Appendix D to the CNPA. Upon the affiliation, Donegal Mutual's expectation is that Donald H. Nikolaus, Donegal Mutual's Chief Executive Officer, may become Chairman of the Board of Directors of SFMIC.

Upon the consummation of a potential demutualization, Donegal Mutual currently anticipates that the current SFMIC officers would remain in effect, subject to the retirement plans of Mr. Wilcox, but that those officers would then report to their functional counterparts at Donegal Mutual, some of whom would become officers of SFMIC.

40. *Will SFMIC's officers and employees be responsible only to persons appointed by SFMIC's board, or does this agreement contemplate that Donegal's officers and employees will direct and supervise any SFMIC employees?*

Section 2(a) of the Services Agreement provides that Donegal Mutual will provide advice and assistance to officers and employees of SFMIC, and Section 2(b) provides that Donegal Mutual will consult with such officers and employees. The implementation and execution of Donegal Mutual's advice, assistance and consulting will be solely the responsibility of SFMIC's officers and employees who in turn will be responsible to SFMIC's board of directors. It is important to remember that one of the principal benefits to SFMIC of the affiliation with Donegal Mutual is to enable SFMIC to reduce its expense ratio which is high relative to published industry averages, implement state-of-the-art technology systems and to enable SFMIC to compete more effectively for business.

41. *Will SFMIC's board establish its own policies and procedures for each of the management functions listed in (2)(a) (i) - (vii) or will Donegal officers and employees impose policies and procedures upon SFMIC's employees that have not been approved by SFMIC's board?*

SFMIC's board of directors will establish its own policies and procedures for each of the management functions listed in Sections 2(a)(i) through (vii) of the Services Agreement. Donegal Mutual's officers and employees will not impose policies and procedures upon SFMIC employees whether or not approved by SFMIC's board of directors. SFMIC's board of

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directors will have oversight of the performance of SFMIC's officers, all of whom are expected to continue in office after consummation of the affiliation.

42. *Will SFMIC maintain at its home office building copies of its complete federal and state tax returns, its complete general ledger and accounting records, and policyholder and premium records?*

Following the affiliation, SFMIC will maintain at its home office complete hard copies of its federal and state tax returns, its complete general ledger and accounting records of policyholders and premium records to the extent required by Wisconsin law. Electronic copies of all SFMIC records will be available on-line at all times.

43. *Section (3)(b)(ii) discussed a process for binding arbitration between SFMIC and Donegal in the event of a dispute about expense allocation. This office has been skeptical of the value of an arbitration clause between affiliated entities, as disputes would ordinarily be resolved by a person with executive authority over each affiliate. OCI requests that it be notified of submission of any dispute to arbitration between SFMIC and Donegal, and that if the arbitration provision is retained that notice to OCI be included in this section.*

Donegal Mutual is prepared to delete the arbitration provision if that is the intent of your comment, subject to concurrence by SFMIC. SFMIC has requested such a provision because SFMIC believes that such a provision is in the best interests of SFMIC's policyholders because it provides an equitable basis for the resolution of any disputes. Further, Donegal Mutual does not understand the premise of your comment because Section 3(b)(ii) provides that any issue would be resolved by an independent arbitrator appointed in accordance with the rules of the American Arbitration Association. If the arbitration clause is retained, Donegal Mutual is agreeable to providing a copy of any notice of arbitration to OCI and having the Services Agreement provide for such notice.

As a matter of history, in the 27 years during which Donegal Mutual has had services agreements in effect, it has never had any dispute with the affiliated insurance company, much less arbitration, about fees and costs.

44. *Sections (3)(c) and (3)(d) describe how the costs of any arbitration or dispute are to be allocated between the parties. It appears that SFMIC would be completely responsible for the costs of both sides unless Donegal's officers, directors, employees or agents committed negligence, willful misconduct or fraud. Why did the parties not agree to split equally the costs of an arbitration or dispute unless there was negligence, willful misconduct or fraud by one party or the other?*

Donegal Mutual respectfully believes that your comment may possibly reflect a misinterpretation of Sections 3(c) and 3(d) of the Services Agreement. In Donegal Mutual's

opinion, those sections do not apply to arbitrations of the type discussed in Donegal Mutual's response to comment 43 where costs would be assessed as determined by the independent arbitrator. In Donegal Mutual's opinion, Sections 3(c) and 3(d) are mirror-image provisions under which the potential third-party liabilities created by the provision of services by Donegal Mutual to SFMIC or by SFMIC to Donegal Mutual are borne by the party receiving the services unless the party providing the services is negligent, engages in willful misconduct or commits fraud.

### *Technology License Agreement*

45. *Section 2(d) states that Sheboygan Falls agents who are so designated by SFMIC will have access to and use of Donegal's WritePro and WriteBiz systems. If policies are written by Sheboygan Falls agents using the Donegal systems, would the policy be written and issued by Donegal or by SFMIC?*

SFMIC's agents write for SFMIC. The customizing of the WritePro or WriteBiz systems that will occur will result in the ability on the part of SFMIC to have its policies rated, underwritten and issued electronically. To the extent a SFMIC agent were also to become a licensed agent of Donegal Mutual, the agent would utilize a SFMIC or Donegal Mutual WritePro or WriteBiz submission depending on the insurance product being selected by the agent and issued to the policyholder. Because the parties intend that Donegal Mutual will issue commercial products and personal lines products in Wisconsin that are complimentary to those issued by SFMIC, neither SFMIC nor Donegal Mutual expect that WritePro and WriteBiz access of the SFMIC agents to be a problem.

46. *Section 3 (a) includes language that the maximum amount of costs charged by Donegal to SFMIC would not exceed \$100,000. Is the limit of \$100,000 intended as an annual limit or an aggregate limit for the project regardless of its duration?*

The \$100,000 limit referred to in Section 3(a) applies to Donegal Mutual's costs in customizing the Applications so that SFMIC can acquire the physical capacity to use the Applications in SFMIC's name and is basically a one-time installation charge. Thereafter, SFMIC would reimburse Donegal Mutual under the Services Agreement for SFMIC's appropriate allocation of on-going IT operating costs.

47. *Also in Section 3(a) it is stated that the above limitation excludes licensing fees and third party vendor costs. Please provide a reasonable estimate of the total costs to SFMIC for all of the licensing fees and third party vendor costs, to the nearest \$100,000.*

The licensing fees and third party vendor costs that SFMIC would bear are the costs and licensing fees that third party vendors will charge to allow licensing rights for the

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utilization of their software systems by SFMIC. Donegal Mutual estimates that the initial cost would not exceed \$50,000 and that the annual license and maintenance fees should not exceed \$50,000 per year. Assuming SFMIC had used the Donegal Mutual IT system for all of 2006 and based upon licensing fees and third party vendor costs paid by Donegal Mutual and DGI in 2006, SFMIC's 2006 allocation for all IT costs, including those estimated fees and costs described above of \$50,000, would have been approximately \$150,000.

48. *Section 3(b)(1) describes Donegal's method of allocating IS costs among users, which includes aggregating internal and external costs, and dividing by the number of years those systems are reasonably expected to be useful, and then allocating the annual cost by premium volume. In the event that the actual useful life of a system exceeds the expected useful life, does Donegal stop billing its affiliates for cost recovery once the initial development cost is paid back, or does Donegal continue to bill the annual cost as long as the system operates? For example, if Donegal spent \$500,000 on a system expected to be useful for 5 years (\$100,000 annual cost), but the system actually was useful for 8 years, would Donegal bill its affiliates for only the originally expected 5 years @ \$100,000/year, or would Donegal continue to bill its affiliates for the entire 8 years @ \$100,000/year?*

Once a cost is fully recovered, there are no more charges under Donegal Mutual's accounting system. Therefore, under the hypothetical facts in your comment, \$100,000 would be charged for five years not eight years. The actual working of the IT allocation is somewhat more complicated because every year Donegal Mutual makes upgrades to its IT system.

The initial programming cost to SFMIC is limited by provisions of the CNPA to \$100,000. After the initial programming, SFMIC will incur substantial ongoing costs of maintaining and operating the overall IT systems and software. The Technology Agreement included as Appendix E to the CNPA limits the annual ongoing costs to SFMIC to 1% of its annual net written premium, which is the approximate percentage that each of the Donegal Mutual affiliates currently incurs as its share of ongoing IT expense.

49. *Sections 3(d) and (e) describe how the costs of any arbitration or dispute are to be allocated between the parties. This office has been skeptical of the value of an arbitration clause between affiliated entities, as disputes would ordinarily be resolved by a person with executive authority over each affiliate. (1) OCI requests that it be notified of submission of any dispute to arbitration between SFMIC and Donegal, and that if the arbitration provision is retained that notice to OCI be included in this section. (2) It appears that SFMIC would be completely responsible for the costs of both sides unless Donegal's officers, directors, employees or agents committed negligence, willful misconduct or fraud. Why did the parties not agree to split equally the costs of an arbitration or dispute unless there was negligence, willful misconduct or fraud by one party or the other?*

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Once again, Donegal Mutual respectfully believes you may have possibly misinterpreted these sections, and Donegal Mutual refers to its response to the similar issue raised by your comment 44.

***Employment Agreements***

50. *We have no questions about the employment agreements at this time.*

***Reinsurance and Retrocession Agreement***

51. *Since the purpose of this agreement is for Donegal to reinsure and retrocede 100% of SFMIC's business, without any transfer of risk to Donegal, why are there exclusions in Article (3) of the contract?*

Donegal Mutual has included exclusions because there is a transfer of risk in terms of legal obligations of the parties, even though there is no transfer of risk under NAIC accounting rules. If Donegal Mutual were to assume SFMIC's book of business on January 1 of a given year and SFMIC then reassumed the book of business on the same date and SFMIC then became insolvent during that year, Donegal Mutual would be obligated to pay the liabilities. Donegal Mutual also references its response to comment 6.

52. *This office has been skeptical of the value of an arbitration clause between affiliated entities, as disputes would ordinarily be resolved by a person with executive authority over each affiliate without arbitration. Is the arbitration clause required by Pennsylvania law? OCI requests that it be notified of submission of any dispute to arbitration between SFMIC and Donegal, and that if the arbitration provision is retained that provision of notice to OCI be included in this section.*

Donegal Mutual does not understand OCI's concerns with an independent arbitration to resolve an issue compared to litigation, which is the other alternative. Assuming the concurrence of SFMIC, Donegal Mutual is prepared to eliminate the arbitration provision or to amend the agreement to provide for notice to OCI. Donegal Mutual also references its response to comment 43.

***Proposed Bylaws for Sheboygan Falls Mutual Insurance Company***

53. *Who are the four directors who will retire from SFMIC?*

SFMIC has advised Donegal Mutual that the four SFMIC directors who will retire upon the consummation of the affiliation will be Gerald J. Ziegler, Merlin A. Moths, Gene H. Specht and Tom A. Heidenreiter.

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54. *Which directors will be in Classes A, B and C in the event the affiliation occurs, and which Class of directors will expire in which year?*

The board of directors of Sheboygan Falls is currently divided into three classes, with three directors in the 2008 and 2009 classes and two directors in the 2010 class. The 2008 class is currently comprised of James H. Fasse, Merlin A. Moths and Kenneth F. Maurer; the 2009 class is currently comprised of Gerald J. Ziegler, Gene H. Specht and Tom A. Heidenreiter and the 2010 class is currently comprised of Lee F. Wilcox and Thomas A. Scribner. Upon the consummation of the affiliation, the 2010 class would have four members who would be: Lee F. Wilcox, Thomas A. Scribner, Donald H. Nikolaus and Frederick W. Dreher; the 2009 class would have three members and consist of Philip H. Glatfelter, II, Scott A. Berlucchi and Dennis J. Bixenman and the 2008 class would consist of three members who would be Kenneth F. Maurer, James H. Fasse and R. Richard Sherbahn.

55. *Section 2.1 discusses group policies. Does SFMIC issue group policies, or does it have plans to do so? If yes, please explain. If not, is this language needed?*

Although SFMIC does not currently issue group policies, it could do so in the future. Section 2.1 is modeled after the by-laws of Donegal Mutual and DGI's insurance subsidiaries and Donegal Mutual believes the language is not harmful in any respect and the language enhances the flexibility of SFMIC. Therefore, Donegal Mutual prefers to include this language.

56. *Will directors be required to be policyholders of SFMIC, or be required to be residents of Wisconsin?*

Directors of SFMIC are required to be policyholders of SFMIC by the proposed By-laws of SFMIC but are not required to be residents of the State of Wisconsin.

57. *Where will original signed board minutes, committee reports and documents reviewed during board and committee meetings be maintained? OCI would expect all of these to be maintained at SFMIC's home office building, but there appears to be no clear provision in the Bylaws.*

All original signed board minutes, committee reports and documents reviewed during board and committee meetings will be maintained at SFMIC's home office.

58. *4.6 - Please explain why SFMIC would need to have board meetings outside of the State of Wisconsin since the company is licensed and does business only in Wisconsin.*

Wisconsin law expressly permits a Wisconsin corporation to hold its board meetings within or without the State of Wisconsin. One practical reason is that after consummation of

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the affiliation, SFMIC will have out-of-state residents as directors and may conduct certain meetings of SFMIC's board of directors at which such members are present by conference telephone.

59. 4.11 - *Who will be elected to the Executive Committee? Where will the Executive Committee meet? Please explain why the Executive Committee should not submit its decisions and actions to the Board of Directors for its approval. Please explain whether the Executive Committee could vote to close the Sheboygan Falls offices after year 5 or whether that decision must be submitted to the full board of directors. Please explain whether the Executive Committee can suspend, alter, continue or terminate any committee or the powers and functions thereof. Please add appropriate language to limit the authority of the Executive Committee in light of agreements in the CNPA. Would the proposed Executive Committee comply with s. 611.56(2), including its composition as required under s. 611.51(2) to (4)?*

The Executive Committee will consist of three persons, one of whom will be Lee H. Wilcox, one of whom will be Donald H. Nikolaus and one of whom will be Philip H. Glatfelter, II.

The proposed By-laws of SFMIC permit the executive committee to exercise the authority of the full board of directors of SFMIC between meetings of the board of directors to the extent permitted by Wisconsin law. Since Wisconsin law is silent as to the closing of the home office of a Wisconsin-domiciled insurance company, that power could theoretically be exercised by the executive committee after the five-year period. However, because the express language of the CNPA requires the affirmative vote of eight members of SFMIC's board of directors, in practical effect SFMIC's executive committee would not have the authority to close the home office of SFMIC in the second five-year period.

The authority of an executive committee is created by a By-law provision or a board of directors' resolution. Under basic principles of corporate governance, Donegal Mutual does not believe that the executive committee of SFMIC, could by itself, amend, suspend or terminate any provision establishing its authority. We believe the appropriate location for procedural limitations on covenants is in the CNPA, which will only be in effect during the period of affiliation.

The proposed Executive Committee language in SFMIC's By-laws satisfies the requirements of s.611.56(2) because the Executive Committee does not have the authority to take any action that would be inconsistent with Wisconsin law, and its composition satisfies s.611.51(2) to (4).

60. *Article 5 - Who will be elected to Officer positions (CEO, President, Secretary and Treasurer) in the event the affiliation occurs? How many Vice President positions will be established, which will have the title "executive", "senior" or a department or functional title, and who will be elected to each of the Vice-President positions? Who will be designated as the Chief Financial Officer?*

The employment agreements filed as appendices to the CNPA call for each of the existing executive officers of SFMIC to continue in office with the same title and the same responsibilities as each of them currently has. There will be no new officers at the time of affiliation with the probable exception of Donald H. Nikolaus becoming Chairman of SFMIC's board of directors. There will be no change in the management structure of SFMIC after the affiliation.

61. *In section 5.9(a) of the CNPA, there is language asserting that four SFMIC directors will be designees of Sheboygan Falls, and six directors will be designees of Donegal; and that Donegal agrees to cause its designees to nominate residents of the Greater Sheboygan Falls area to succeed the initial Sheboygan Falls directors. Also, in the event that SFMIC becomes a subsidiary of Donegal or DGI, or five years after the Closing Date, Donegal agrees to maintain an "appropriate Wisconsin presence" on the converted SFMIC's board. There is no language in the proposed Bylaws that carries out these agreements in the CNPA, please explain why the language is missing, or add the appropriate language to the Bylaws to carry out these agreements. Please explain what "an appropriate Wisconsin presence" means, numerically. Also, please explain why the initial four Sheboygan Falls designee directors should not control the nomination of the future Sheboygan area directors; in the absence of that process it appears Donegal could select successor directors who live in the area but who are not policyholders of SFMIC.*

The term "appropriate Wisconsin presence" is not an arithmetic formula and is not intended to be an arithmetic formula. An appropriate presence is not a number. The term is intended to provide SFMIC and Donegal Mutual with an appropriate level of flexibility as the future unfolds, but provides a commitment to maintain Wisconsin representation on any future demutualized SFMIC board. Donegal Mutual is not prepared to agree to any fixed formula for "appropriate Wisconsin presence".

Donegal Mutual repeats the substance of its response to comment 10. The Donegal Mutual designees on the SFMIC board will act in accordance with their fiduciary duties to the policyholders of SFMIC. Furthermore, it seems unlikely that Donegal Mutual would breach an undertaking in a context where such a failure by Donegal Mutual would impact OCI's decision-making process in contemplated future actions requiring OCI approval.

Donegal Mutual's covenants in the CNPA are self-executing. Donegal Mutual does not believe there is any legal or practical requirement that these covenants be included in SFMIC's By-laws. Donegal Mutual therefore requests that you reconsider this comment.

Donegal Mutual believes that director nominees should be selected by majority vote of all directors and not by a minority. Furthermore, Donegal Mutual believes that SFMIC will be successful in expanding its presence throughout Wisconsin and that SFMIC could benefit from a more geographically diverse group of Wisconsin-resident directors. The proposed SFMIC By-laws filed as an Appendix to the CNPA require that all directors of SFMIC be policyholders of SFMIC.

62. *In section 5.9(b) of the CNPA, there is language asserting that between the fifth and tenth anniversary of the Closing Date, Donegal agrees to not relocate or close the existing facilities of SFMIC in its current location in the city of Sheboygan Falls, unless such relocation or closure is approved by the affirmative vote of eight members of the Board of Directors of Sheboygan Falls.*

*Why is this agreement not included in the proposed Bylaws of SFMIC? Also, in the absence of designees of the current SFMIC board being able to control the nomination of successor Sheboygan area directors, it would appear that Donegal would be able to control the selection of all of the Sheboygan area directors, making the 8/10 requirement meaningless in the event that Donegal wanted to close the Sheboygan Falls office five years and one day after Closing.*

The covenant is not included in the proposed By-laws of SFMIC because we and the other attorneys involved in the transaction do not believe such inclusion is necessary for the enforceability of the provision.

You are correct that Donegal Mutual will be able to control the selection of the Sheboygan Falls area directors. Donegal Mutual has operated under the principle that it should exercise its powers responsibly. Furthermore, only one of the Donegal Mutual designees is a Donegal Mutual employee. The Donegal Mutual directors all have reputations that reflect integrity and a demonstrated ability to make independent decisions in the exercise of their fiduciary duties.

Donegal Mutual believes that this provision, which arose from a compromise during the negotiations with SFMIC, if further restricted, would represent an inappropriate limit on Donegal Mutual's future discretion. SFMIC has advised Donegal Mutual that SFMIC believes retention of the current language is in the best interests of SFMIC and its policyholders.

We would be pleased to discuss Donegal Mutual's responses with you after you have had an opportunity to review them. We would like Anne E. Ross, Donegal Mutual's

Office of the Commissioner of Insurance

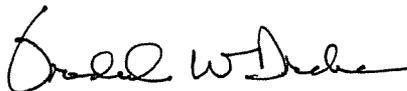
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Wisconsin counsel, to participate with us in any such discussion. Donegal Mutual would also be pleased, if you believe it would be beneficial to a resolution of the open issues, to meet with you in your offices in Madison if you so request.

Thank you in advance for your review and consideration of Donegal Mutual's responses.

Sincerely,

A handwritten signature in black ink, appearing to read "Frederick W. Dreher". The signature is fluid and cursive, with a large initial "F" and "D".

Frederick W. Dreher

cc: Guenther Ruch  
Roger Peterson  
Donald H. Nikolaus  
Lee F. Wilcox  
Jeffrey D. Miller  
Connie L. O'Connell, Esq.  
Anne E. Ross, Esq.  
Richard L. Cohen, Esq.