



State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

Jim Doyle, Governor
Sean Dilweg, Commissioner

Wisconsin.gov

February 16, 2007

125 South Webster Street • P.O. Box 7873
Madison, Wisconsin 53707-7873
Phone: (608) 266-3585 • Fax: (608) 266-9935
E-Mail: information@oci.state.wi.us
Web Address: oci.wi.gov

DONALD H NIKOLAUS PRESIDENT AND CEO
DONEGAL MUTUAL INSURANCE COMPANY
1195 RIVER ROAD
MARIETTA PA 17547

Re: Form A filing

Dear Mr. Nikolaus:

This letter is in response to the Form A filing by Donegal Mutual regarding the acquisition of control of Sheboygan Falls Mutual Insurance Company, dated December 28, 2006.

In this letter, "CNPA" and "NPA" refer to the Contribution Note Purchase Agreement; "SFMIC" refers to Sheboygan Falls Mutual Insurance Company; "Donegal" and "DMIC" refer to Donegal Mutual Insurance Company, and "DGI" refers to Donegal Group, Inc.

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?
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 LeMars' common stock.
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.
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?
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.

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.

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?
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.
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?
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.
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.
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.
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.
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.

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

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:

18. Preamble, par. 2 – delete references to CNPA and NPA, and delete reference to terms being defined in the CNPA;
19. Preamble, par. 3 – delete reference to the NPA;
20. Preamble, par. 4. – delete entire paragraph (“...mandatory and voluntary repayment ...”);
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;
22. par. 1 (c) – please delete this paragraph, as it is not in the OCI glossary note;
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;
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;
25. par. 3(e) – please delete this section, as it is not in the OCI glossary note;
26. par. 3(f) – please delete reference to the NPA in this section;
27. par. 3(g) – please delete references to the NPA in this section;
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;
29. par. (5) – this language is not in the OCI glossary agreement and should be deleted;
30. par. (6) – this language is not in the OCI glossary agreement and should be deleted;
31. par. (7) – this language is not in the OCI glossary agreement and should be deleted.
32. The proposed agreement did not include the paragraph 1. in OCI's glossary agreement, please add that paragraph.
33. Please explain why Donegal felt it was necessary to include references to the CNPA and/or NPA in this agreement.

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.

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?
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?
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.
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?

Services Agreement

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

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?

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?
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.
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?
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?

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?
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.

Proposed Bylaws for Sheboygan Falls Mutual Insurance Company

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

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

Mr. Donald H. Nikolaus
February 16, 2007
Page 7

Thank you for your assistance and cooperation with these questions, and I look forward to your responses.

Sincerely,

A handwritten signature in black ink, appearing to read "Peter Medley". The signature is fluid and cursive, with a large loop at the end of the last name.

Peter Medley
Insurance Examiner Supervisor
Bureau of Financial Analysis and Examinations

cc by e-mail:

Frederick W. Dreher, Duane Morris LLP
Anne E. Ross, Foley & Lardner LLP