



State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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DATE: May 18, 2007
TO: Roger A. Peterson
FROM: Peter Medley
David Jensen
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Exh #	11
Date	5/18/2007
Case	07-C30859
Ins. Comm.	

SUBJECT: In the Matter of the Acquisition of Control of Sheboygan Falls Mutual Insurance Company by Donegal Mutual Insurance Company. (Case No. 07-C30859)

This memorandum is regarding the proposed Acquisition of Control of Sheboygan Falls Mutual Insurance Company ("SFMIC"), a Wisconsin mutual fire and casualty insurance company by Donegal Mutual Insurance Company ("DMIC"), a Pennsylvania mutual fire insurance company.

DESCRIPTION OF THE TRANSACTION

Overview

SFMIC is a Wisconsin domiciled property and casualty insurer which began business in 1899. It is not part of an insurance holding company.

DMIC is a Pennsylvania domiciled property and casualty insurer which began business in 1889. It is licensed in eleven states. It is not currently licensed in Wisconsin. It is the parent in a ten-company holding company. Five of these companies are insurance companies owned through DMIC's publicly-traded affiliate, Donegal Group Inc. DMIC has voting control of Donegal Group Inc.

DMIC proposes to acquire control of SFMIC through a Contribution Note Purchase Agreement. DMIC will provide \$3,500,000 as the purchase price of a contribution note issued by SFMIC. As a part of this transaction, DMIC will also enter into a Services Agreement, a Technology License Agreement, and a Reinsurance and Retrocession Agreement with SFMIC. SFMIC would also execute employment agreements with each of its current executives and make certain proposed changes to the company Bylaws. To complete the transaction, four of the eight current members of the SFMIC Board of Directors will resign, SFMIC will expand the board to ten members and the remaining board members will elect six new directors that DMIC has nominated. DMIC currently anticipates that SFMIC will demutualize at some time, and that Donegal Group Inc. would purchase the newly demutualized company. The possible future demutualization is not the subject of this hearing.

Scope of Wisconsin's Regulatory Concern

Section 611.72, Wis. Stat., requires the Office of the Commissioner of Insurance (OCI) to approve a plan for acquisition of control if it finds, after a hearing, that the plan would not violate the law or be contrary to the interests of the insureds of any domestic corporation or of the Wisconsin insureds of any participating nondomestic corporation.

OBSERVATIONS BASED ON REVIEW OF DOCUMENTS AND ON INQUIRIES

Format and Informational Sufficiency of the Form A

The Form A filing was prepared in a format that complies with s. Ins 40.02, Wis. Adm. Code. The information contained in the filing and in the supplementary information obtained by OCI in connection with review of this filing is sufficient for OCI to make a decision concerning the proposed plan.

Legality and Fairness of the Proposed Plan

My review of the Form A included a review of the following items:

1. Contribution Note Purchase Agreement by and between Sheboygan Falls Mutual Insurance Company by Donegal Mutual Insurance Company;
2. Corporate Organizational Chart identifying relationships among Donegal Mutual Insurance Company and its affiliates before the proposed transaction;
3. Officers and Directors Biographical Information;
4. Amendment 1 to the Contribution Note Purchase Agreement entered into by and between DMIC and SFMIC;
5. The Contribution Note to be executed by SFMIC and received by DMIC;
6. The proposed Services Agreement between SFMIC and DMIC as amended;
7. The proposed Technology License Agreement between SFMIC and DMIC as amended;
8. The proposed Reinsurance and Retrocession Agreement between SFMIC and DMIC as amended;
9. The Employment Agreements of the executives of SFMIC;
10. The proposed Amended and Restated Bylaws of Sheboygan Falls Mutual Insurance Company;
11. Statutory Basis Financial Statements of DMIC for the years 2001 through 2006;
12. Donegal Group Inc. 2005 Annual Report;
13. Donegal Group Inc. 2005 10-K;

The following is a brief summary of the agreements included in the list of items reviewed above:

Contribution Note Purchase Agreement

There is a Contribution Note Purchase Agreement, dated December 27, 2006, by and between Sheboygan Falls Mutual Insurance Company and Donegal Mutual Insurance Company. DMIC proposes to acquire control of the Board of Directors of SFMIC through the purchase of a contribution note from SFMIC, to enter into a Services Agreement with SFMIC and to enter into a Technology License Agreement with SFMIC, and to enter into a Reinsurance and Retrocession Agreement with SFMIC. SFMIC would also execute employment agreements with each of its current executives and make certain proposed changes to the company Bylaws. At the time of the execution of this contract, four of the eight current members of the SFMIC Board of Directors will resign, SFMIC will expand the board to ten members and the remaining board members will elect the six new directors that DMIC has nominated.

DMIC has made certain commitments regarding SFMIC:

(1) that until the later of (i) repayment of the Contribution Note or (ii) termination of the Technology License Agreement, Sheboygan Falls will use its best efforts to assure that the Board of Directors of Sheboygan Falls shall consist of ten members, four of whom shall be designees of Sheboygan Falls and six of whom shall be designees of DMIC. DMIC agrees, for a period of not less than five years from the Closing Date, to cause its designees on the Sheboygan Falls board to nominate persons as successors to the initial SFMIC designees who are residents of the greater Sheboygan Falls area. Following the later to occur of (i) five years from the Closing Date, or (ii) the date on which Sheboygan Falls shall have become a wholly owned subsidiary of DMIC or of Donegal Group Inc., DMIC agrees to maintain an appropriate Wisconsin presence on the Board of Directors of Sheboygan Falls.

(2) that for a period of five years from the Closing Date, DMIC will not take any action to relocate or close the existing facilities of Sheboygan Falls. For a period from the fifth to the tenth anniversary of the Closing Date, DMIC agrees not to take any action to relocate or close the existing facilities 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.

Contribution Note

The contribution note to be executed between DMIC and SFMIC requires DMIC to pay \$3,500,000 to SFMIC. The note bears an interest rate of one-half of one percent below the prime rate as long as that amount is legal under Wisconsin Insurance regulations and is between 5.5% and 8.0%. The note is due on December 31, 2010 or at any time that Donegal no longer has a majority of directors on the Board of Directors of SFMIC. Payment of interest and principal is subject to prior approval by OCI.

Services Agreement

The Services Agreement to be executed between DMIC and SFMIC requires DMIC to provide advice and assistance to SFMIC in the areas of underwriting, claims, reinsurance, investments, data processing, personnel and professional services, and financial reporting. It shall also advise and consult with SFMIC concerning tax administration, accounting and policyholder services. Payment shall be made based upon actual cost incurred. This agreement is valid through December 31, 2010.

Technology License Agreement

The Technology License Agreement to be executed between DMIC and SFMIC allows SFMIC to use the Information Technology systems that DMIC currently uses for policy administration, claims administration, investment management, payroll administration, accounting, and other general applications. Applications will be customized as necessary at SFMIC's cost. The maximum amount of such costs charged to SFMIC will not exceed \$100,000. Upon completion of the customization of the applications, charges for the services and license will be determined using the calculations currently performed to determine the allocation of information systems costs among the companies that currently receive information services from DMIC. DMIC will host the system and be responsible for administration and maintenance of it. SFMIC will pay for all direct costs for services required specifically by SFMIC. Other costs will be allocated as they are to other companies that use DMIC's IT systems.

Reinsurance and Retrocession Agreement

The Reinsurance and Retrocession Agreement to be executed between DMIC and SFMIC allows SFMIC to cede all non-excluded policies to DMIC. All of these in turn will be retroceded by DMIC to SFMIC. During the normal course of business, this should not affect any operating results since there is no net payment by either party, but it establishes a legal obligation of DMIC regarding

SFMIC's policies that AM Best takes into account in providing a rating for SFMIC. The companies anticipate that the AM Best rating of SFMIC will improve through this agreement. From the NAIC perspective there is no transfer of risk for accounting purposes.

A question arose as to whether the retrocession of business from DMIC to SFMIC would make DMIC a policyholder of SFMIC for the purposes of any future demutualization of SFMIC under s. 611.76, Wis. Stat., in which case DMIC's retrocession could be viewed as 50% of SFMIC's total premium volume and would entitle DMIC to 50% of the value of SFMIC. DMIC has submitted a letter from its CEO, Donald Nikolaus, stating that DMIC would not assert any rights as a policyholder of SFMIC for the purposes of s. 611.76, Wis. Stat., by reason of the retrocessional reinsurance agreement; however DMIC expresses no position as to the legal interpretation of s. 611.76 in this situation.

The Employment Agreements of the executives of SFMIC

Under the terms of the employment agreements with the executives of SFMIC, pay, benefits and length of contracted service are included. For the contract with Lee Wilcox, the President and CEO of SFMIC, the agreement allows Mr. Wilcox to change from full-time employment to part time employment after two years. This contract would be until his 65th birthday on May 27, 2011, whether he chooses to become a part-time employee or not. All other agreements are for three years from the date of execution.

Amended and Restated Bylaws of SFMIC

In order to meet the terms and conditions of the Contribution Note Purchase Agreement, SFMIC will need to make certain changes to the bylaws of the company. These changes include increasing the size of the Board of Directors from eight to ten (six Donegal nominees and four residents of the greater Sheboygan Falls area) and making some changes to help fit SFMIC into the DMIC group. Notable among these changes are those which allow the board to meet outside of Wisconsin; and establish an executive committee that will have board level control between board meetings. The bylaws would be further amended to allow the four incumbent Sheboygan Falls area directors to nominate their successors at the expiration of their terms, subject to the approval of the full board; and require certain transactions with Donegal to be approved by the board members that are Sheboygan Falls area directors.

This review of the Form A and the component agreements of the proposed plan, with due consideration to supplementary information filed in response to examiner inquiries, discloses no basis for denial of the application on a point of law.

I can find no basis on which execution of the proposed transactions disclosed in the Form A should not be regarded as reasonable and fair to each participating insurer and to each participating insurer's policyholders, within the scope of Wisconsin's regulatory concern. This conclusion cannot and does not apply to agreements that have not been proposed at this time or provided for OCI's review.

Satisfaction of Licensing Requirements Maintained

Execution of the transactions disclosed in the Form A according to the plan indicated would have no effect on the ability of Sheboygan Falls Mutual Insurance Company or any other participating insurer to maintain their existing licenses to write the lines of insurance for which they are presently licensed.

Effect on Competition within the Wisconsin Insurance Marketplace

In 2006, Sheboygan Falls Mutual Insurance Company wrote approximately \$10 million in direct premium written primarily on homeowners and commercial multiple peril and automobile insurance in the State of Wisconsin. This is the only state where SFMIC writes business, and each line represents well under 1% of the total insurance written in that line in the State of Wisconsin. The company is not one of the twenty

largest insurers in the State of Wisconsin in any line that it writes business. Given the highly competitive nature of the property and casualty insurance market in Wisconsin, the small size of SFMIC and the fact that Donegal Mutual Insurance Company is not currently licensed to write insurance in Wisconsin, this acquisition will not create a monopoly or substantially lessen competition in Wisconsin.

Future Plans after the Change in Control

DMIC intends to provide a number of back office and technology services through the Services Agreement and the Technology License Agreement. It intends to improve the AM Best rating of SFMIC by providing a \$3,500,000 contribution note and by entering into a Reinsurance and Retrocession Agreement with SFMIC. At some point in the future DMIC intends to ask for permission to demutualize SFMIC as part of a planned acquisition of SFMIC by Donegal Group Inc., an affiliate of DMIC. DMIC will maintain the facilities of SFMIC in Sheboygan Falls for at least five years.

Financial Soundness of Prospective Affiliates

DMIC is a mutual insurance company with a surplus of \$136 million. It began operations in 1889 and is the parent company of an insurance holding company

As of December 31, 2006, DMIC's annual statement reported assets of \$296 million, liabilities of \$160 million, policyholders' surplus of \$136 million, and net income for 2006 of \$14 million. DMIC has an RBC ratio in excess of 1,000%.

Donegal Group, Inc., owned in part (47.5%) and controlled (62.4% of voting power) by DMIC, had assets of \$838 million, liabilities of \$511 million, and stockholders' equity of \$327 million as of March 31, 2007 on a GAAP basis. Total revenue for fiscal year 2006 was \$330 million, net income was \$40 million.

The financial condition of Donegal Mutual Insurance Company, individually, and its holding company system taken as a whole, are unlikely to jeopardize the financial stability of Sheboygan Falls Mutual Insurance Company, or to prejudice the interests of their respective Wisconsin policyholders.

Change in Control

Completion of the transactions proposed in the Form A will result in a change in control for Sheboygan Falls Mutual Insurance Company. The plan would result in a \$3,500,000 contribution note funded by Donegal Mutual Insurance Company and majority control of the board of SFMIC by DMIC.

Competence and Integrity of Prospective Management

DMIC provided copies of biographical reports for their officers and directors. Review of the composition of the board and management of DMIC discloses no basis for disapproval of the Form A.

Summary of Observations

1. The Form A filing was prepared in a format that complies with s. Ins 40.02, Wis. Adm. Code. The information contained in the Form A filing and its supplements are sufficient for the transaction.
2. The plan would not violate the law or be contrary to the interests of Sheboygan Falls Mutual Insurance Company or its policyholders.
3. After the acquisition of control, Sheboygan Falls Mutual Insurance Company will not experience a change that would cause it to become unable to satisfy the licensure requirements for it to write the lines of insurance business for which it is presently licensed.

4. It is evident that this transaction will not create a monopoly or substantially lessen competition in any type or line of insurance in Wisconsin.
5. The financial condition of Donegal Mutual Insurance Company, individually, and its holding company system taken as a whole, are unlikely to jeopardize the financial stability of Sheboygan Falls Mutual Insurance Company, or to prejudice the interests of their respective Wisconsin policyholders.
6. The plan results in a change in control for Sheboygan Falls Mutual Insurance Company. There are no plans or proposals to liquidate the domestic mutual insurance corporation, Sheboygan Falls Mutual Insurance Company, or to sell its assets (other than investment portfolio transactions in the ordinary course of business). The company may be demutualized and purchased by Donegal Group, Inc. at a future time. The anticipated business, corporate structure, and management following the acquisition has been described in the Form A and its supplements, but such plans are subject to additional change and development. The plan does not appear to be adverse to Sheboygan Falls Mutual Insurance Company, or its policyholders, or to conflict with the public interest.
7. The competence and integrity of the persons who would control the operation of Sheboygan Falls Mutual Insurance Company are such that it is in the interest of their respective policyholders and of the public to permit the proposed plan.

RECOMMENDATION

I recommend that the plan for the acquisition of control of Sheboygan Falls Mutual Insurance Company by Donegal Mutual Insurance Company be approved.