ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.
Form 10-Q
May 10, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2013

OR

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

Commission file number 001-35547

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**36-4392754**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

222 Merchandise Mart, Suite 2024

Chicago, IL 60654

(Address of principal executive offices)

(312) 506-1200

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of April 30, 2013, there were 177,263,200 shares of the registrant s $0.01 par value common stock outstanding.

Table of Contents

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

FORM 10-Q

TABLE OF CONTENTS

		PAGE
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements (unaudited)	
	Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012	3
	Consolidated Statements of Operations for the three months ended March 31, 2013 and 2012	4
	Consolidated Statements of Comprehensive Income (Loss) for the three months ended March 31, 2013 and 2012	5
	Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012	6
	Notes to Consolidated Financial Statements	7
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	25
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	47
Item 4.	Controls and Procedures	47
PART II. OTHER INFORMATION		48
Item 1.	Legal Proceedings	48
Item 2.	Unregistered Sales of Equity Securities, Use of Proceeds and Issuer Purchases of Equity Securities	48
Item 6.	Exhibits	48
SIGNATURES		49

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except per share amounts)	March 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 92,228	$ 103,956
Accounts receivable, net of allowance of $39,086 and $37,838 at March 31, 2013 and December 31, 2012, respectively	351,772	337,024
Deferred taxes, net	56,958	56,499
Prepaid expenses and other current assets	118,343	110,023
Total current assets	619,301	607,502
Long-term marketable securities	1,700	1,706
Fixed assets, net	162,318	155,494
Software development costs, net	92,909	95,579
Intangible assets, net	504,126	426,986
Goodwill	1,189,761	1,039,364
Deferred taxes, net	7,529	7,529
Other assets	45,169	50,304
Total assets	$ 2,622,813	$ 2,384,464
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 73,008	$ 45,874
Accrued expenses	94,086	93,100
Accrued compensation and benefits	46,650	44,124
Deferred revenue	327,863	290,653
Current maturities of long-term debt and capital lease obligations	85,715	79,305
Total current liabilities	627,322	553,056
Long-term debt	458,601	362,697
Deferred revenue	24,159	19,750
Deferred taxes, net	112,360	125,913
Other liabilities	66,080	38,707
Total liabilities	1,288,522	1,100,123
Commitments and contingencies		
Stockholders equity:		
Preferred stock: $0.01 par value, 1,000 shares authorized, no shares issued and outstanding at March 31, 2013 and December 31, 2012	0	0
Common stock: $0.01 par value, 349,000 shares authorized at March 31, 2013 and December 31, 2012; 261,763 and 177,091 shares issued and outstanding at March 31, 2013, respectively, 257,087 and 172,415 shares issued and outstanding at December 31, 2012, respectively	2,618	2,571

Treasury stock: at cost, 84,672 shares at March 31, 2013 and December 31, 2012	(278,036)	(278,036)
Additional paid-in capital	1,639,273	1,577,260
Accumulated deficit	(29,122)	(17,530)
Accumulated other comprehensive (loss) income	(442)	76
Total stockholders equity	1,334,291	1,284,341
Total liabilities and stockholders equity	$ 2,622,813	$ 2,384,464

The accompanying notes are an integral part of these consolidated financial statements.

3

Table of Contents

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended March 31,	
(In thousands, except per share amounts)	**2013**	**2012**
Revenue:		
System sales	$ 27,031	$ 37,240
Professional services	61,084	71,486
Maintenance	117,708	118,284
Transaction processing and other	141,243	137,702
Total revenue	347,066	364,712
Cost of revenue:		
System sales (excluding amortization of software development costs and acquisition-related assets shown below)	13,329	16,636
Amortization of software development costs and acquisition-related assets	19,539	14,949
Professional services	57,582	61,702
Maintenance	36,597	36,004
Transaction processing and other	85,591	79,744
Total cost of revenue	212,638	209,035
Gross profit	134,428	155,677
Selling, general and administrative expenses	104,232	97,317
Research and development	50,978	36,122
Amortization of intangible assets	7,501	9,255
(Loss) income from operations	(28,283)	12,983
Interest expense	(4,637)	(3,854)
Interest income and other, net	8,131	392
(Loss) income before income taxes	(24,789)	9,521
Benefit (provision) for income taxes	13,197	(3,708)
Net (loss) income	($ 11,592)	$ 5,813
(Loss) earnings per share basic and diluted	($ 0.07)	$ 0.03

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

	Three Months Ended March 31,	
(In thousands)	**2013**	**2012**
Net (loss) income	($ 11,592)	$ 5,813
Other comprehensive (loss) income :		
Unrealized gain on marketable securities, net of tax	4	5
Derivatives:		
Unrealized loss on derivative financial instruments	(6)	(743)
Reclassification adjustment for loss included in net (loss) income	359	475
Tax effect	(136)	106
Unrealized loss on derivative financial instruments, net of tax	217	(162)
Change in foreign currency translation adjustments	(739)	907
Total other comprehensive (loss) income	(518)	750
Comprehensive (loss) income	($ 12,110)	$ 6,563

The accompanying notes are an integral part of these consolidated financial statements.

5

Table of Contents

ALLSCRIPTS HEALTHCARE SOLUTIONS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	**Three Months Ended March 31, 2013**	**2012**
Cash flows from operating activities:		
Net (loss) income	($ 11,592)	$ 5,813
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	40,827	35,216
Stock-based compensation expense	8,004	7,727
Excess tax benefits from stock-based compensation	(1,654)	(101)
Deferred taxes	(14,080)	3,338
Other (gains) losses	(8,256)	86
Changes in operating assets and liabilities, net of business combinations		
Accounts receivable, net	(10,905)	(6,993)
Prepaid expenses and other assets	(12,832)	(9,462)
Accounts payable	21,735	15,412
Accrued expenses	(7,616)	(2,603)
Accrued compensation and benefits	849	(3,338)
Deferred revenue	35,462	28,570
Other liabilities	(576)	929
Net cash provided by operating activities	39,366	74,594
Cash flows from investing activities:		
Capital expenditures	(16,435)	(19,423)
Capitalized software	(7,871)	(13,268)
Cash paid for business acquisitions, net of cash acquired	(148,802)	0
Sales and maturities of other investments	12,516	15
Net cash used in investing activities	(160,592)	(32,676)
Cash flows from financing activities:		
Proceeds from issuance of common stock	7,931	2,015
Excess tax benefits from stock-based compensation	1,654	101
Taxes paid related to net share settlement of equity awards	(1,648)	(2,298)
Payments of capital lease obligations	(182)	(232)
Credit facility payments	(27,614)	(24,522)
Credit facility borrowings, net of issuance costs	129,043	0
Repurchase of common stock	0	(547)
Net cash provided by (used in) financing activities	109,184	

	Class A	Class B	Class A	Class B
Basic net income per share:				
Numerator:				
Allocation of net income	$ 3,642	$ 915	$ 10,270	$ 2,607
Denominator:				
Weighted-average shares outstanding	19,891,096	5,576,775	19,833,576	5,576,775

Basic net income per share	$	0.18	$	0.16	$	0.52	$	0.47
Diluted net income per share:								
Numerator:								
Allocation of net income	$	3,642	$	915	$	10,270	$	2,607
Denominator:								
Number of shares used in basic computation		19,891,096		5,576,775		19,833,576		5,576,775
Weighted-average effect of dilutive securities								
Director and employee stock options						110,064		
Number of shares used in per share computations		19,891,096		5,576,775		19,943,640		5,576,775
Diluted net income per share	$	0.18	$	0.16	$	0.52	$	0.47

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Number of shares	3,413,932	1,025,500	3,423,432	1,032,667

4 Reinsurance

Atlantic States has participated in a pooling agreement with Donegal Mutual since 1986 under which each company places all of its direct written business into the pool, and Atlantic States and Donegal Mutual then share the underwriting results of the pool in accordance with the terms of the pooling agreement. From July 1, 2000 through February 29, 2008, Atlantic States had a 70% share of the results of the pool, and Donegal Mutual had a 30% share of the results of the pool. Effective March 1, 2008, Donegal Mutual and Atlantic States amended the pooling agreement to increase Atlantic States share of the results of the pool to 80%. Donegal Mutual transferred approximately $11.9 million of cash and net liabilities to Atlantic States in connection with this amendment to the pooling agreement as of March 1, 2008 as follows:

		(in thousands)
Unearned premiums (net of reinsurance)	$	13,626
Less: Ceding commissions		(1,709)
Net liabilities transferred	$	11,917

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

management, is equivalent to a company with at least an A- rating. The following information relates to the external reinsurance Atlantic States, Southern and Donegal Mutual have in place during 2009 and 2008:

excess of loss reinsurance, under which losses are automatically reinsured, through a series of reinsurance agreements, over a set retention ($750,000 and $600,000 for 2009 and 2008, respectively), and

catastrophe reinsurance, under which Donegal Mutual, Atlantic States and Southern recover, through a series of reinsurance agreements, 100% of an accumulation of many losses resulting from a single event, including natural disasters, over a set retention ($3.0 million for 2009 and 2008).

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

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

We renewed our 2009 reinsurance program at rates comparable to 2008, largely attributable to our decision to increase our excess of loss reinsurance retention from $600,000 to $750,000 effective January 1, 2009. We made no other significant changes to our third-party reinsurance or other reinsurance agreements between our insurance subsidiaries and Donegal Mutual during the six months ended June 30, 2009.

5 Investments

The amortized cost and estimated fair values of our fixed maturities and equity securities at June 30, 2009 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 2,000	$ 99	$	$ 2,099
Obligations of states and political subdivisions	66,063	2,116	149	68,030
Corporate securities	8,342	40	98	8,284
Residential mortgage-backed securities	4,962	88		5,050
Totals	$ 81,367	$ 2,343	$ 247	$ 83,463

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 17,667	$ 113	$ 442	$ 17,338
Obligations of states and political subdivisions	363,867	8,113	4,782	367,198
Corporate securities	28,625	578	260	28,943
Residential mortgage-backed securities	78,593	2,304	71	80,826
Fixed maturities	488,752	11,108	5,555	494,305
Equity securities	3,398	2,976	479	5,895
Totals	$ 492,150	$ 14,084	$ 6,034	$ 500,200

The amortized cost and estimated fair values of our fixed maturities and equity securities at December 31, 2008 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Held to Maturity				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 8,517	$ 176	$	$ 8,693
Obligations of states and political subdivisions	76,451	1,955	231	78,175
Corporate securities	8,342	57	392	8,007
Residential mortgage-backed securities	6,568	35	29	6,574
Totals	$ 99,878	$ 2,223	$ 652	$ 101,449

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Available for Sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 6,526	$ 105	$	$ 6,631
Obligations of states and political subdivisions	341,663	5,321	9,981	337,003
Corporate securities	24,518	208	790	23,936
Residential mortgage-backed securities	76,304	1,960	18	78,246
Fixed maturities	449,011	7,594	10,789	445,816
Equity securities	2,939	3,015	59	5,895
Totals	$ 451,950	$ 10,609	$ 10,848	$ 451,711

The amortized cost and estimated fair value of our fixed maturities at June 30, 2009, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(in thousands)	
Held to maturity		
Due in one year or less	$ 6,601	$ 6,587
Due after one year through five years	6,017	6,130
Due after five years through ten years	60,427	62,350
Due after ten years	3,360	3,346
Residential mortgage-backed securities	4,962	5,050
Total held to maturity	$ 81,367	$ 83,463

Available for sale		
Due in one year or less	$ 14,389	$ 14,604
Due after one year through five years	77,294	79,578
Due after five years through ten years	116,297	118,493
Due after ten years	202,179	200,804
Residential mortgage-backed securities	78,593	80,826
Total available for sale	$ 488,752	$ 494,305

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

	Six Months Ended June 30,	
	2009	2008
	(in thousands)	
Gross realized gains:		
Fixed maturities	$ 133	$ 651
Equity securities	619	337
	$ 752	$ 988
Gross realized losses:		
Fixed maturities	$ 1	$
Equity securities	47	966
	48	966
Net realized gains (losses)	$ 704	$ 22

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at June 30, 2009 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 11,178	$ 442	$	$
Obligations of states and political subdivisions	88,902	3,070	52,930	1,862
Corporate securities	6,175	169	2,074	188
Residential mortgage-backed securities	5,173	65	537	6
Equity securities	1,563	479		
Total	$ 112,991	$ 4,225	$ 55,541	$ 2,056

We held fixed maturities and equity securities with unrealized losses representing declines that we considered temporary at December 31, 2008 as follows:

	Less than 12 months		12 months or longer	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)			
Obligations of states and political subdivisions	$ 117,360	$ 6,881	$ 65,627	$ 3,331
Corporate securities	16,781	449	2,536	733

Residential mortgage-backed securities	2,925	24	2,929	23
Equity securities	484	59		
Total	$ 137,550	$ 7,413	$ 71,092	$ 4,087

Of our total fixed maturity securities with an unrealized loss at June 30, 2009, we classified 135 securities with a fair value of $154.0 million and an unrealized loss of $5.6 million as available-for-sale and carried them at fair value on our balance sheet, while we classified 11 securities with a fair value of $12.9 million and an unrealized loss of $246,568 as held-to-maturity on our balance sheet and carried them at amortized cost.

Of our total fixed maturity securities with an unrealized loss at December 31, 2008, we classified 179 securities with a fair value of $184.1 million and an unrealized loss of $10.8 million as available-for-sale and carried them at fair value on our balance sheet, while we classified 23 securities with a fair value of $24.1 million and an unrealized loss of $652,450 as held-to-maturity on our balance sheet and carried them at amortized cost.

We have no direct exposure to sub-prime residential mortgage-backed securities and hold no collateralized debt obligations. Substantially all of the unrealized losses in our fixed maturity investment

portfolio have resulted from general market conditions and the related impact on our fixed maturity investment valuations. We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, when we consider the decline in value of an individual investment to be other than temporary, we write the investment down to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations. We individually monitor all investments for other-than-temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in such an unrealized loss position for more than six months, we assume there has been an other-than-temporary decline in value. We held three equity securities that were in an unrealized loss position at June 30, 2009. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we consider these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the security prior to recovery. If it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. To determine whether a credit loss has occurred, we compare the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider a credit loss to have occurred. If we consider a credit loss to have occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, whether the financial condition of the issuer of a security is deteriorating, the occurrence of industry, company and geographic events that have negatively impacted the value of a security and rating agency downgrades. We determined that no investments trading below cost had declined on an other-than-temporary basis during the first six months of 2009. We determined that certain investments trading below cost had declined on an other-than-temporary basis and included losses of $851,085 in our results of operations for these investments during the first six months of 2008.

We amortize premiums and discounts on debt securities over the life of the security as an adjustment to yield using the effective interest method. We compute realized investment gains and losses using the specific identification method.

We amortize premiums and discounts for mortgage-backed debt securities using anticipated prepayments.

We account for investments in affiliates using the equity method of accounting in accordance with Accounting Principles Board (APB) Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock. Under the equity method, we record our investment at cost, with adjustments for our share of affiliate earnings and losses as well as changes in affiliate equity due to unrealized gains and losses.

6 Segment Information

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

	Three Months Ended June 30,	
	2009	2008
	(in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	$ 28,065	$ 30,988
Personal lines	59,604	56,341
Net premiums earned	87,669	87,329
GAAP adjustments	(129)	
GAAP premiums earned	87,540	87,329
Net investment income	5,266	5,794
Realized investment gains (losses)	445	(674)
Other	1,544	1,522
Total revenues	$ 94,795	$ 93,971
Income before income taxes:		
Underwriting income (loss):		
Commercial lines	$ 1,603	$ 3,343
Personal lines	(4,362)	(2,633)
SAP underwriting income (loss)	(2,759)	710
GAAP adjustments	1,143	1,398
GAAP underwriting income (loss)	(1,616)	2,108
Net investment income	5,266	5,794
Realized investment gains (losses)	445	(674)
Other	1,039	590
Income before income taxes	$ 5,134	$ 7,818

	Six Months Ended June 30,	
	2009	2008
	(in thousands)	
Revenues:		
Premiums earned:		
Commercial lines	$ 57,324	$ 59,836
Personal lines	119,011	109,501
Net premiums earned	176,335	169,337
GAAP adjustments	(445)	
GAAP premiums earned	175,890	169,337
Net investment income	10,624	11,486
Realized investment gains	704	22
Other	3,064	2,918
Total revenues	$ 190,282	$ 183,763
Income before income taxes:		
Underwriting income (loss):		
Commercial lines	$ 2,021	$ 6,459
Personal lines	(10,229)	(7,065)
SAP underwriting loss	(8,208)	(606)
GAAP adjustments (1)	1,339	4,544
GAAP underwriting income (loss)	(6,869)	3,938
Net investment income	10,624	11,486
Realized investment gains	704	22
Other	887	875
Income before income taxes	$ 5,346	$ 16,321

(1) GAAP adjustments for the six months ended June 30, 2008 included an increase in deferred acquisition costs, which offset the ceding commissions

that we included in the transfer of net liabilities from Donegal Mutual discussed in Note 4 Reinsurance.

7 Subordinated Debentures

On October 29, 2003, we received $10.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on October 29, 2033 and are callable at our option, at par, after October 29, 2008. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At June 30, 2009, the interest rate on the debentures was 4.90%.

On May 24, 2004, we received $5.0 million in net proceeds from the issuance of subordinated debentures. The debentures mature on May 24, 2034 and are callable at our option, at par, after May 24, 2009. The debentures carry an interest rate equal to the three-month LIBOR rate plus 3.85%, which is adjustable quarterly. At June 30, 2009, the interest rate on the debentures was 4.51%.

8 Share Based Compensation

Effective January 1, 2006, we adopted SFAS No. 123(R), Share-Based Payment which requires the measurement of all share-based payments to employees, including grants of stock options, using a fair-value-based method and the recording of such expense in our consolidated statements of income. In determining the expense we recorded for stock options granted to directors and employees of our subsidiaries and affiliates other than Donegal Mutual, the fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The significant assumptions we utilized in applying the Black-Scholes option pricing model are the risk-free interest rate, expected term, dividend yield and expected volatility.

Under SFAS No. 123(R), the compensation expense for our stock compensation plans that we charged against income before income taxes was $48,691 and $43,070 for the three months ended June 30, 2009 and 2008, respectively, with a corresponding income tax benefit of $17,042 and $15,075, respectively. The compensation expense for our stock compensation plans that we charged against income before income taxes was $110,391 and $86,696 for the six months ended June 30, 2009 and 2008, respectively, with a corresponding income tax benefit of $38,637 and $30,344, respectively. As of June 30, 2009, our total unrecognized compensation cost related to nonvested share-based compensation granted under our stock compensation plans was $133,521. We expect to recognize this cost over a weighted average period of 2.6 years.

SFAS No. 123(R) does not establish accounting requirements for share-based compensation to nonemployees. We continue to account for share-based compensation to employees and directors of Donegal Mutual under the provisions of FIN No. 44 and EITF 00-23, which state that when we grant share-based compensation to employees of a controlling entity, we should measure the fair value of the award at the grant date and recognize the fair value as a dividend to the controlling entity. These provisions apply to options we granted to employees and directors of Donegal Mutual, the employer of a majority of the employees that provide services to us. We recorded implied dividends of $5,298 and $0 for the three months ended June 30, 2009 and 2008, respectively. We recorded implied dividends of $32,923 and $39,964 for the six months ended June 30, 2009 and 2008, respectively.

We received cash from option exercises under all stock compensation plans for the three months ended June 30, 2009 and 2008 of $0 and $104,845, respectively. We realized tax benefits for the tax deductions from option exercises of share-based compensation of $0 and $6,824 for the three months ended June 30, 2009 and 2008, respectively. We received cash from option exercises under all stock compensation plans for the six months ended June 30, 2009 and 2008 of $0 and $1,449,643, respectively. We realized tax benefits for the tax deductions from option exercises of share-based compensation of $0 and $631,757 for the six months ended June 30, 2009 and 2008, respectively.

9 Fair Value Measurements

As of January 1, 2008, we adopted SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under GAAP and requires expanded disclosures about fair value measurements. SFAS No. 157 establishes a hierarchy that ranks the quality and reliability of inputs, or assumptions, used in the determination of fair value and requires financial assets and liabilities carried at fair value to be classified and disclosed in one of the following three categories:

Level 1 quoted prices in active markets for identical assets and liabilities;

Level 2 directly or indirectly observable inputs other than Level 1 quoted prices; and

Level 3 unobservable inputs not corroborated by market data.

For investments that have quoted market prices in active markets, we use the quoted market price as fair value and include these investments in Level 1 of the fair value hierarchy. We classify publicly traded equity securities as Level 1. When quoted market prices in active markets are not available, we base fair values on quoted market prices of comparable instruments or broker quotes we obtain from independent pricing services through a bank trustee. We classify our fixed maturity investments as Level 2. Our fixed maturity investments consist of U.S. Treasury securities and obligations of U.S, government corporations and agencies, obligations of states and political subdivisions, corporate securities and residential mortgage-backed securities. We had no investments classified as Level 3 at June 30, 2009.

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. The pricing services do not use broker quotes in determining the fair values of our investments.

We review the

estimates of fair value provided by the pricing services to determine if the estimates obtained are representative of market prices based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. As of June 30, 2009 and 2008, we received one estimate per security from one of the pricing services and we priced all but an insignificant amount of our fixed maturity and equity investments using those prices. In our review of the estimates provided by the pricing services as of June 30, 2009 and December 31, 2008, we did not identify any discrepancies and we did not make any adjustments to the estimates the pricing services provided.

We present our cash and short-term investments at estimated fair value. The carrying value in the balance sheet for premium and reinsurance receivables and payables approximate their fair values. The carrying amounts reported in the balance sheet for our subordinated debentures approximate their fair values due to their variable rate nature.

We evaluate assets and liabilities on a recurring basis to determine the appropriate level at which to classify them for each reporting period. The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of June 30, 2009:

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 17,338	$	$ 17,338	$
Obligations of states and political subdivisions	367,198		367,198	
Corporate securities	28,942		28,942	
Residential mortgage-backed securities	80,827		80,827	
Equity securities	5,895	4,852	1,043	
Total	$ 500,200	$ 4,852	$ 495,348	$

The following table presents our fair value measurements for our investments in available-for-sale fixed maturity and equity securities as of December 31, 2008:

	Fair Value Measurements Using		
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

	Fair Value	(Level 1)		
		(in thousands)		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 6,630	$	$ 6,630	$
Obligations of states and political subdivisions	337,003		337,003	
Corporate securities	23,936		23,936	
Residential mortgage-backed securities	78,247		78,247	
Equity securities	5,895	4,971	924	
Total	$ 451,711	$ 4,971	$ 446,740	$

10 Income Taxes

Effective January 1, 2007, we adopted Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. As of June 30, 2009 and June 30, 2008, respectively, we had no material unrecognized tax benefits or accrued interest and penalties. Our 2006 federal tax return is under audit, and tax years 2005, 2007 and 2008 remained open for examination as of June 30, 2009.

11 Impact of New Accounting Standards

In April 2009, the FASB issued FASB Staff Position (FSP) FAS 115-2 and Financial Accounting Standard (FAS) 124-2, Recognition and Presentation of Other-Than-Temporary Impairments. FSP FAS 115-2 and FAS 124-2 provide guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on debt and equity securities. FSP FAS 115-2 and FAS 124-2 are effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for interim and annual periods ending after March 15, 2009. Effective April 1, 2009, we adopted FSP FAS 115-2 and FAS 124-2. For the interim period ended June 30, 2009, there was no cumulative effect adjustment as all securities determined to be other-than-temporary-impaired in previous periods have been sold. Beginning on April 1, 2009, we analyzed our debt securities for other-than-temporary-impairment adjustments using guidance in FSP FAS 115-2 and FAS 124-2.

In April 2009, the FASB issued FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly. FSP FAS 157-4 provides guidelines for making fair value measurements that are more consistent with the principles presented in SFAS No. 157, Fair Value Measurements. FSP FAS 157-4 is effective for interim and annual periods ending after June 15, 2009, with early adoption permitted for interim and annual periods ending after March 15, 2009. Effective April 1, 2009, we adopted FSP FAS 157-4. The adoption of FSP FAS 157-4 expanded certain fair value disclosures but had no effect on our results of operations, financial condition or liquidity.

In April 2009, the FASB issued FSP FAS 107-1 and Accounting Principles Board (APB) 28-1, Interim Disclosures about Fair Value of Financial Instruments. FSP FAS 107-1 and APB 28-1 amend FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments for interim periods as well as in annual financial statements. FSP FAS 107-1 and APB 28-1 are effective for interim and annual periods ending after June 30, 2009, with early adoption permitted for interim and annual periods ending after March 15, 2009. Effective June 30, 2009, we adopted FSP FAS 107-1 and APB 28-1. Footnote 9 includes the disclosures required by FSP FAS 107-1 and APB 28-1.

In May 2009, the FASB issued FAS 165, Subsequent Events . FAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. FAS165 is effective for interim and annual periods ending after June 15, 2009. Effective June 30, 2009, we adopted FAS 165. We have evaluated subsequent events for potential recognition or disclosure through August 7, 2009, the date we issued the consolidated financial statements included in this Quarterly Report on Form 10-Q.

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

You should read the following information in conjunction with the historical financial information and the notes thereto included in this Quarterly Report on Form 10-Q and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2008.

Critical Accounting Policies and Estimates

Our financial statements are combined with those of our insurance subsidiaries and are presented on a consolidated basis in accordance with GAAP.

Our insurance subsidiaries make estimates and assumptions that can have a significant effect on amounts and disclosures that we report in our financial statements. The most significant estimates relate to our insurance subsidiaries reserves for property and casualty insurance unpaid losses and loss expenses, valuation of investments and determination of other-than-temporary impairment in the value of investments and policy acquisition costs. While we believe our estimates and the estimates of our insurance subsidiaries are appropriate, the ultimate amounts may differ from the amounts estimated. We regularly review these estimates and reflect any adjustment considered necessary in our current results of operations.

Liability for Unpaid Losses and Loss Expenses

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

Our insurance subsidiaries maintain liabilities for the payment of unpaid losses and loss expenses with respect to both reported and unreported claims. It is the intent of our insurance subsidiaries that their liabilities for loss expenses will cover the ultimate costs of settling all losses, including investigation and litigation costs from those losses. Our insurance subsidiaries base the amount of their liabilities for reported losses primarily upon a case-by-case evaluation of the type of risk involved, knowledge of the circumstances surrounding each claim and the provisions of our insurance policies relating to the type of loss. Our insurance subsidiaries determine the amount of their liabilities for unreported claims and loss expenses on the basis of historical information by line of insurance. Our insurance subsidiaries account for inflation in the reserving function through analysis of costs and trends and reviews of historical reserving results. Our insurance subsidiaries closely monitor their liabilities and recompute them periodically using new information on reported claims and a variety of statistical techniques. Our insurance subsidiaries do not discount their liabilities for unpaid losses and loss expenses.

Our liability estimates can change over time because of unexpected changes in assumptions related to our insurance subsidiaries external environment and, to a lesser extent, assumptions as to our insurance subsidiaries internal operations. For example, our insurance subsidiaries have experienced a decrease in claims frequency on workers compensation claims during the past several years while claims severity has gradually increased. These trend changes give rise to greater uncertainty as to the pattern of future loss settlements on bodily injury claims. Related uncertainties regarding future trends include the cost of medical technologies and procedures and changes in the utilization of medical procedures. Assumptions related to our insurance subsidiaries external environment include the absence of significant changes in tort law and the legal environment that increase liability exposure, consistency in judicial interpretations of insurance coverage and policy provisions and the rate of loss cost inflation. Internal assumptions include accurate measurement of the impact of rate changes and changes in policy provisions and consistency in the quality and characteristics of business written within a given line of business among other items. To the extent our insurance subsidiaries determine that underlying factors impacting their assumptions have changed, our insurance subsidiaries make adjustments they consider appropriate for those changes in their liabilities. Accordingly, our insurance subsidiaries ultimate liability for unpaid losses and loss expenses will likely differ from the amount recorded at June 30, 2009. For every 1% change in our estimate of our insurance subsidiaries liability for unpaid losses and loss expenses, net of reinsurance recoverable, the effect on our pre-tax results of operations would be approximately $1.7 million.

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

Excluding the impact of severe weather events, our insurance subsidiaries have noted slight downward trends in the number of claims incurred and the number of claims outstanding at period ends relative to their premium base in recent years across most of their lines of business. However, the amount of the average claim outstanding has increased gradually over the past several years as the property and casualty insurance industry has experienced increased litigation trends, periods in which economic

conditions extended the estimated length of disabilities, increased medical loss cost trends and a general slowing of settlement rates in litigated claims. We may make adjustments in the future to reflect subsequent developments. However, on the basis of our insurance subsidiaries internal procedures, which analyze, among other things, their prior assumptions, their experience with similar cases and historical trends such as reserving patterns, loss payments, pending levels of unpaid claims and product mix, as well as court decisions, economic conditions and public attitudes, we believe that our insurance subsidiaries have made adequate provision for their liability for unpaid losses and loss expenses as of June 30, 2009.

Atlantic States participation in the pool with Donegal Mutual exposes it to adverse loss development on the business of Donegal Mutual that is included in the pool. However, pooled business represents the predominant percentage of the net underwriting activity of both companies, and Donegal Mutual and Atlantic States share any adverse risk development of the pooled business according to their respective participation in the pool. The business in the pool is homogeneous and each company has a percentage share of the entire pool as provided in the pooling agreement. Since substantially all of the business of Atlantic States and Donegal Mutual is pooled and the results shared by each company according to its respective participation level under the terms of the pooling agreement, the intent of the underwriting pool is to produce a more uniform and stable underwriting result from year to year for each company than they would experience individually and to spread the risk of loss between Atlantic States and Donegal Mutual.

The risk profiles of the business Atlantic States and Donegal Mutual write have historically been, and continue to be, substantially similar. The same executive management and underwriting personnel administer products, classes of business underwritten, pricing practices and underwriting standards of Donegal Mutual and our insurance subsidiaries.

In addition, Donegal Mutual and our insurance subsidiaries, operating together as the Donegal Insurance Group share a combined business plan to achieve market penetration and underwriting profitability objectives. The products our insurance subsidiaries and Donegal Mutual offer are generally complementary, thereby allowing Donegal Insurance Group to offer a broader range of products to a given market and to expand Donegal Insurance Group s ability to service an entire personal lines or commercial lines account. Distinctions within the products of Donegal Mutual and our insurance subsidiaries generally relate to specific risk profiles targeted within similar classes of business, such as preferred tier products compared to standard tier products, but we do not allocate all of the standard risk gradients to one company. Therefore, the underwriting profitability of the business directly written by the individual companies will vary. However, as the risk characteristics of all business written directly by Donegal Mutual and Atlantic States are homogenized within the pool and each company shares the results according to each company s participation level, each company realizes its pro rata share of the underwriting results of the pool.

Our insurance subsidiaries unpaid liability for losses and loss expenses by major line of business as of June 30, 2009 and December 31, 2008 consisted of the following:

	June 30, 2009	December 31, 2008
	(in thousands)	
Commercial lines:		
Automobile	$ 21,535	$ 19,758
Workers compensation	38,349	36,667
Commercial multi-peril	27,820	27,808
Other	1,627	1,893
Total commercial lines	89,331	86,126
Personal lines:		
Automobile	63,619	60,939
Homeowners	11,159	11,796
Other	1,986	2,445
Total personal lines	76,764	75,180
Total commercial and personal lines	166,095	161,306
Plus reinsurance recoverable	83,402	78,503
Total liability for unpaid losses and loss expenses	$ 249,497	$ 239,809

We have evaluated the effect on our insurance subsidiaries unpaid loss and loss expense reserves and our stockholders equity in the event of reasonably likely changes in the variables we considered in establishing the loss and loss expense reserves of our insurance subsidiaries. We established the range of reasonably likely changes based on a review of changes in accident year development by line of business and applied those changes to our insurance subsidiaries loss reserves as a whole. The selected range does not necessarily indicate what could be the potential best or worst case or the most likely scenario. The following table sets forth the estimated effect on our insurance subsidiaries unpaid loss and loss expense reserves and our stockholders equity in the event of reasonably likely changes in the variables considered in establishing loss and loss expense reserves:

Change in Loss and Loss Expense Reserves Net of Reinsurance	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of June 30, 2009	Percentage Change in Equity as of June 30, 2009(1)	Adjusted Loss and Loss Expense Reserves Net of Reinsurance as of December 31, 2008	Percentage Change in Equity as of December 31, 2008(1)
		(dollars in thousands)		
(10.0)%	$ 149,486	2.9%	$ 145,175	2.9%
(7.5)	153,638	2.2	149,208	2.2
(5.0)	157,790	1.5	153,241	1.4

(2.5)	161,943	0.7	157,273	0.7
Base	166,095		161,306	
2.5	170,247	-0.7	165,339	-0.7
5.0	174,400	-1.5	169,371	-1.4
7.5	178,552	-2.2	173,404	-2.2
10.0	182,705	-2.9	177,437	-2.9

(1) Net of income tax effect.

Investments

We make estimates concerning the valuation of our investments and the recognition of other-than-temporary declines in the value of our investments. For equity securities, when we consider the decline in value of an individual investment to be other than temporary, we write down the investment to its fair value, and we reflect the amount of the write-down as a realized loss in our results of operations. We individually monitor all investments for other-than-temporary declines in value. Generally, if an individual equity security has depreciated in value by more than 20% of original cost, and has been in such an unrealized loss position for more than six months, we assume there has been an other-than-temporary decline in value. We held three equity securities that were in an unrealized loss position at June 30, 2009. Based upon our analysis of general market conditions and underlying factors impacting these equity securities, we consider these declines in value to be temporary. With respect to a debt security that is in an unrealized loss position, we first assess if we intend to sell the debt security. If we intend to sell the debt security, we recognize the impairment loss in our results of operations. If we do not intend to sell the debt security, we determine whether it is more likely than not that we will be required to sell the security prior to recovery. If it is more likely than not that we will be required to sell the debt security prior to recovery, we recognize an impairment loss in our results of operations. If it is more likely than not that we will not be required to sell the debt security prior to recovery, we then evaluate whether a credit loss has occurred. To determine whether a credit loss has occurred, we compare the amortized cost of the debt security to the present value of the cash flows we expect to collect. If we expect a cash flow shortfall, we consider a credit loss to have occurred. If we consider a credit loss to have occurred, we consider the impairment to be other than temporary. We then recognize the amount of the impairment loss related to the credit loss in our results of operations, and we recognize the remaining portion of the impairment loss in our other comprehensive income, net of applicable taxes. In addition, we may write down securities in an unrealized loss position based on a number of other factors, including the fair value of the investment being significantly below its cost, whether the financial condition of the issuer of a security is deteriorating, the occurrence of industry, company and geographic events that have negatively impacted the value of a security and rating agency downgrades. We determined that no investments trading below cost had declined on an other-than-temporary basis during the first six months of 2009. We determined that certain investments trading below cost had declined on an other-than-temporary basis and included losses of $851,085 in our results of operations for these investments during the first six months of 2008.

We present our investments in available-for-sale fixed maturity and equity securities at estimated fair value. The estimated fair value of a security may differ from the amount that could be realized if the security was sold in a forced transaction. In addition, the valuation of fixed maturity investments is more subjective when markets are less liquid, increasing the potential that the estimated fair value does not reflect the price at which an actual transaction would occur. We utilize nationally recognized independent pricing services to estimate fair values for our fixed maturity and equity investments. We generally obtain one price per security. The pricing services utilize market quotations for fixed maturity and equity securities that have quoted prices in active markets. For fixed maturity securities that generally do not trade on a daily basis, the pricing services prepare estimates of fair value measurements using proprietary pricing applications, which include available relevant market information, benchmark yields, sector curves and matrix pricing. The pricing services do not use broker quotes in determining the fair values of our investments. We review the estimates of fair value provided by the pricing services to determine if the estimates obtained are representative of market prices based upon our general knowledge of the market, our research findings related to unusual fluctuations in value and our comparison of such values to execution prices for similar securities. As of June 30, 2009 and December 31,2008, we received one estimate per security from one of the pricing services and we priced all but an insignificant amount of our fixed maturity and equity investments using those prices. In our review of the estimates provided by the pricing services as of June 30, 2009 and December 31, 2008, we did not identify any discrepancies and we did not make any adjustments to the estimates the pricing services provided.

Policy Acquisition Costs

Our insurance subsidiaries defer their policy acquisition costs, consisting primarily of commissions, premium taxes and certain other underwriting costs that vary with and are primarily related to the production of business. We amortize these costs over the period in which our insurance subsidiaries earn the related premiums. The method we

follow in computing deferred policy acquisition costs limits the amount of such deferred costs to their estimated realizable value, which gives effect to the premiums to be earned, related investment income, losses and loss expenses and certain other costs we expect to incur as our insurance subsidiaries earn the premiums.

Results of Operations Three Months Ended June 30, 2009 Compared to Three Months Ended June 30, 2008

Net Premiums Written. Net premiums written for the three months ended June 30, 2009 were $93.6 million, a decrease of $907,727, or 1.0%, from the $94.5 million of net premiums written for the comparable period in 2008. Personal lines net premiums written increased $3.2 million, or 5.2%, in the second quarter of 2009 compared to the comparable period in 2008. Commercial lines net premiums written decreased $4.1 million, or 12.4%, in the second quarter of 2009 compared to the comparable period in 2008 primarily because of competitive conditions in this market during an uncertain economy.

Net Premiums Earned. Net premiums earned increased to $87.5 million for the second quarter of 2009, an increase of $211,150, or .2%, over the second quarter of 2008. Our insurance subsidiaries earn premiums and recognize them as revenue over the terms of their policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the three months ended June 30, 2009, our net investment income decreased to $5.3 million, compared to $5.8 million for the comparable period one year ago. An increase in our average invested assets from $624.3 million in the second quarter of 2008 to $635.1 million in the second quarter of 2009 was offset by a decrease in our annualized average return to 3.3% in 2009, compared to 3.7% in 2008. The decrease in our annualized average rate of return on investments was primarily due to increased holdings of lower-yielding tax-exempt municipal bonds and short-term U.S. Treasury securities during the second quarter of 2009.

Net Realized Investment Gains (Losses). Net realized investment gains in the second quarter of 2009 were $445,140, compared to net realized investment losses of $673,627 for the comparable period in 2008. We did not recognize any impairment losses during the second quarter of 2009. During the second quarter of 2008, we included impairment losses of $779,585 in net realized investment gains (losses).

Losses and Loss Expenses. Our loss ratio, which is the ratio of incurred losses and loss expenses to premiums earned, for the second quarter of 2009 was 70.7%, an increase from our 64.5% loss ratio for the second quarter of 2008. We experienced weather-related losses of $8 million after reinsurance, adverse prior-accident-year loss reserve development of approximately $3.2 million and the impact of two large workers compensation claims that totaled $1.2 million after reinsurance in the second quarter of 2009. Our commercial lines loss ratio increased to 64.0% for the second quarter of 2009, compared to 56.4% for the second quarter of 2008, primarily due to increases in our commercial automobile and workers compensation loss ratios. Our personal lines loss ratio increased to 74.0% for the second quarter of 2009, compared to 69.5% for the second quarter of 2008, primarily due to increases in our homeowners and private passenger automobile loss ratios.

Underwriting Expenses. Our expense ratio, which is the ratio of policy acquisition costs and other underwriting expenses to premiums earned, for the second quarters of 2009 and 2008 were 31.0% and 32.8%, respectively. Our expense ratio for the second quarter of 2009 reflected decreased expenses incurred for underwriting-based incentive compensation costs as a result of our higher loss ratio compared to the comparable period in 2008 and the cost reduction initiatives we began in 2008.

Combined Ratio. Our combined ratio was 101.8% and 97.6% for the three months ended June 30, 2009 and 2008, respectively. Our combined ratio represents the sum of our loss ratio, expense ratio and dividend ratio, which is the ratio of workers compensation policy dividends incurred to premiums earned.

Interest Expense. Interest expense for the second quarter of 2009 was $198,467 compared to $534,240 for the second quarter of 2008. The lower interest expense in the 2009 period reflected the decrease in average interest rates on our subordinated debentures in the second quarter of 2009 compared to the comparable period in 2008 and the redemption of $15 million of subordinated debentures in August 2008.

Income Taxes. Income tax expense was $745,904 for the second quarter of 2009, representing an effective tax rate of 14.5%, compared to $1.5 million for the second quarter of 2008, representing an effective tax rate of 19.2%. The change in effective tax rates is primarily due to tax-exempt interest income representing a greater proportion of net income before taxes in the second quarter of 2009 compared to the comparable period in 2008.

Net Income and Earnings Per Share. Our net income for the second quarter of 2009 was $4.4 million, or $.18 per share of Class A common stock on a diluted basis and $.16 per share of Class B common stock, compared to net income of $6.3 million, or $.25 per share of Class A common stock on a diluted basis and $.23 per share of Class B common stock, reported for the second quarter of 2008. Our fully diluted Class A shares outstanding for the second quarter of 2008 decreased slightly to 19.9 million, compared to 20.0 million for the second quarter of 2008, as a result of our repurchase of treasury stock. We had 5.6 million Class B shares outstanding for both periods.

Results of Operations Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008

Net Premiums Written. Net premiums written for the six months ended June 30, 2009 were $181.6 million, a decrease of $12.6 million, or 6.5%, over the comparable period in 2008. Net premiums written for the first half of 2008 included a $13.6 million transfer of unearned premiums related to the change in the pooling agreement between Atlantic States and Donegal Mutual effective March 1, 2008. Commercial lines net premiums written decreased $12.3 million, or 17.0%, in the first half of 2009 compared to the comparable period in 2008 primarily because of competitive conditions in this market during an uncertain economy. Personal lines net premiums written in 2009 were unchanged compared to the comparable period in 2008.

Net Premiums Earned. Net premiums earned increased to $175.9 million for the first half of 2009, an increase of $6.6 million, or 3.9%, over the first half of 2008. Premiums are earned, or recognized as revenue, over the terms of our policies, which are one year or less in duration. Therefore, increases or decreases in net premiums earned generally reflect increases or decreases in net premiums written in the preceding twelve-month period compared to the comparable period one year earlier.

Investment Income. For the six months ended June 30, 2009, our net investment income decreased to $10.6 million, compared to $11.5 million for the comparable period one year ago. An increase in average invested assets from $612.0 million in the first half of 2008 to $631.4 million in the first half of 2009 was offset by a decrease in the annualized average rate of return on investments from 3.8% for the first half of 2008 to 3.4% for the first half of 2009. The decrease in our annualized average rate of return on investments was primarily due to increased holdings of lower-yielding tax-exempt municipal bonds and short-term U.S. Treasury securities during the first six months of 2009.

Net Realized Investment Gains. Net realized investment gains in the first half of 2009 were $703,995, compared to $21,729 for the comparable period in 2008. We recognized no impairment charges in the first half of 2009, compared to impairment charges of $851,085 recognized in the first half of 2008. The impairment charges for 2008 were the result of declines in the market value of equity securities that we deemed to be other than temporary. The remaining net realized investment gains in both periods resulted from normal turnover of our investment portfolio.

Losses and Loss Expenses. Our loss ratio in the first half of 2009 was 72.7%, compared to 65.0% in the first half of 2008. Losses and loss expenses increased for the first half of 2009, as we experienced significant weather-related claim activity and unfavorable prior-accident-year loss reserve development largely attributable to weather-related property claims compared to the first half of 2008. The commercial lines loss ratio increased to 65.8% in the first half of 2009, compared to 54.7% in the first half of 2008, primarily due to increases in the commercial automobile, workers compensation and commercial multi-peril loss ratios. The personal lines loss ratio increased from 71.1% in the first half of 2008 to 76.1% in the first half of 2009, primarily due to increases in our homeowners loss ratio.

Underwriting Expenses. Our expense ratio for the first half of 2009 was 31.0%, compared to 32.3% in the first half of 2008. The expense ratio reflected decreased expenses incurred for underwriting-based incentive compensation costs as a result of higher loss ratios compared to the comparable period in 2008 and the cost reduction initiatives we began in 2008.

Combined Ratio. Our combined ratio was 103.9% and 97.7% for the six months ended June 30, 2009 and 2008, respectively. The combined ratio represents the sum of the loss ratio, expense ratio and dividend ratio. The increase in the combined ratio was largely attributable to the increase in the loss ratio for the 2009 period compared to the 2008 period.

Interest Expense. Interest expense for the first half of 2009 was $1.4 million, compared to $1.1 million for the first half of 2008. The higher interest expense in the 2009 period reflected approximately $974,000 related to interest and penalties on contested premium tax litigation, which was offset by a decrease in average interest rates on our

subordinated debentures in the first six months of 2009 compared

to the comparable period in 2008 and the redemption of $15 million of subordinated debentures in August 2008.

Income Taxes. Income tax expense was $788,355 for the first half of 2009, representing an effective tax rate of 14.7%, compared to $3.4 million for the first half of 2008, representing an effective tax rate of 21.1%. The change in effective tax rates is primarily due to tax-exempt interest income representing a greater proportion of net income before taxes in the 2009 period compared to the 2008 period.

Net Income and Earnings Per Share. Our net income for the first half of 2009 was $4.6 million, or $.18 per share of Class A common stock on a diluted basis and $.16 per share of Class B common stock, compared to our net income of $12.9 million, or $.52 per share of Class A common stock on a diluted basis and $.47 per share of Class B common stock, for the first half of 2008. We had 19.9 million diluted Class A shares and 5.6 million Class B shares outstanding for both periods.

Liquidity and Capital Resources

Liquidity is a measure of an entity s ability to secure enough cash to meet its contractual obligations and operating needs as they arise. Our major sources of funds from operations are the net cash flows generated from our insurance subsidiaries underwriting results, investment income and maturing investments.

We have historically generated sufficient net positive cash flow from our operations to fund our commitments and build our investment portfolio, thereby increasing future investment returns. The impact of the pooling agreement between Donegal Mutual and Atlantic States has historically been cash flow positive because of the consistent underwriting profitability of the pool. The pool is settled monthly, thereby resulting in cash flows substantially similar to cash flows that would result from the underwriting of direct business. We have not experienced any unusual variations in the timing of claim payments associated with the loss reserves of our insurance subsidiaries. We maintain significant liquidity in our investment portfolio in the form of readily marketable fixed maturities, equity securities and short-term investments. Our fixed-maturity investment portfolio is structured following a laddering approach, so that projected cash flows from investment income and principal maturities are evenly distributed from a timing perspective, thereby providing an additional measure of liquidity to meet our obligations should an unexpected variation occur in the future. Net cash flows provided by operating activities in the first six months of 2009 and 2008 were $7.7 million and $29.8 million, respectively. The net cash flows provided by operating activities in the first six months of 2008 included an $11.9 million transfer of cash from Donegal Mutual discussed in Note 4 Reinsurance.

We maintain a credit agreement with Manufacturers and Traders Trust Company (M&T) relating to a $35.0 million unsecured, revolving line of credit that will expire in July 2010. As of June 30, 2009, we have the ability to borrow $35.0 million at interest rates equal to M&T s current prime rate or the then current LIBOR rate plus between 1.50% and 1.75%, depending on our leverage ratio. In addition, we pay a fee of 0.15% per annum on the loan commitment amount regardless of usage. The credit agreement requires our compliance with certain covenants, which include minimum levels of our net worth, leverage ratio and statutory surplus and the A.M. Best ratings of our insurance subsidiaries. During the six months ended June 30, 2009, we had no borrowings outstanding under the credit agreement, and we were in compliance with all requirements of the credit agreement.

The following table shows our expected payments for significant contractual obligations as of June 30, 2009.

	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
			(in thousands)		
Net liability for unpaid losses and loss expenses of our insurance subsidiaries	$ 166,095	$ 77,422	$ 73,323	$ 7,125	$ 8,225
Due to Sheboygan policyholders	1,287	1,287			
Subordinated debentures	15,465				15,465
Total contractual obligations	$ 182,847	$ 78,709	$ 73,323	$ 7,125	$ 23,690

24

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

We estimate the date of payment for the subordinated debentures based on their contractual maturities. The debentures are redeemable at our option, at par, after five years from their issuance dates as discussed in Note 7 Subordinated Debentures. The subordinated debentures carry interest rates that vary based upon the three-month LIBOR rate and adjust quarterly. Based upon the interest rates in effect as of June 30, 2009, our annual interest cost associated with the subordinated debentures is approximately $716,000. For every 1% change in the three-month LIBOR rate, the effect on our annual interest cost would be approximately $150,000.

On March 7, 2007, our board of directors authorized a share repurchase program pursuant to which we may purchase up to 500,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We purchased 11,000 and 52,031 shares of our Class A common stock under this program during the three months ended June 30, 2009 and 2008, respectively. We purchased 14,000 and 140,243 shares of our Class A common stock under this program during the six months ended June 30, 2009 and 2008, respectively. We have purchased a total of 494,769 shares of our Class A common stock under this program through June 30, 2009.

On February 23, 2009, our board of directors authorized a share repurchase program, pursuant to which we may purchase up to 300,000 shares of our Class A common stock at prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We did not purchase any shares of our Class A common stock under this program through June 30, 2009.

On July 16, 2009, our board of directors declared quarterly cash dividends of 11.25 cents per share for our Class A common stock and 10.0 cents per share for our Class B common stock, payable August 17, 2009 to stockholders of record as of the close of business on August 3, 2009. There are no regulatory restrictions on the payment of dividends to our stockholders, although there are state law restrictions on the payment of annual dividends greater than 10% of statutory surplus by our insurance subsidiaries to us. Our insurance subsidiaries are required by law to maintain certain minimum surplus on a statutory basis and require prior approval of the applicable domiciliary insurance regulatory authorities for dividends in excess of 10% of statutory surplus. Our insurance subsidiaries are subject to risk-based capital (RBC) requirements. At December 31, 2008, our insurance subsidiaries capital levels were each substantially above the applicable RBC requirements. At January 1, 2009, amounts available for distribution as dividends to us from our insurance subsidiaries without prior approval of their domiciliary insurance regulatory authorities were $18.4 million from Atlantic States, $1.6 million from Southern, $2.8 million from Le Mars, $3.9 million from Peninsula, and $0 from Sheboygan, all of which remained available at June 30, 2009.

As of June 30, 2009, we had no material commitments for capital expenditures.

Equity Price Risk

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

Credit Risk

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

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

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

Impact of Inflation

We establish property and casualty insurance premium rates before we know the amount of unpaid losses and loss expenses or the extent to which inflation may impact such expenses. Consequently, our insurance subsidiaries attempt, in establishing rates, to anticipate the potential impact of inflation.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Our investment mix has shifted slightly due to our continuing shift from taxable to tax-exempt fixed maturity investments during 2009. We have maintained approximately the same duration of our investment portfolio to our liabilities from December 31, 2008 to June 30, 2009.

There have been no material changes to our quantitative or qualitative market risk exposure from December 31, 2008 through June 30, 2009.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

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

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

Item 4T. Controls and Procedures.

Not applicable.

Part II. Other Information

Item 1. Legal Proceedings.

None.

Item 1A. Risk Factors.

Our business, results of operations and financial condition, and, therefore, the value of our Class A common stock and Class B common stock, are subject to a number of risks. For a description of certain risks, we refer to Risk Factors in our 2008 Annual Report on Form 10-K filed with the SEC on March 12, 2009. There have been no material changes during the six months ended June 30, 2009 in the risk factors disclosed in that Form 10-K Report.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Period	(a) Total Number of Shares (or Units) Purchased		(b) Average Price Paid per Share (or Unit)		(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs		(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1	Class A	None	Class A	None	Class A	None	
April 1-30, 2009	Class B	None	Class B	None	Class B	None	
Month #2	Class A	11,000	Class A	$14.64	Class A	11,000	(1)
May 1-31, 2009	Class B	None	Class B	None	Class B	None	
Month #3	Class A	None	Class A	None	Class A	None	
June 1-30, 2009	Class B	None	Class B	None	Class B	None	
	Class A	11,000	Class A	$14.64	Class A	11,000	
Total	Class B	None	Class B	None	Class B	None	

(1) We purchased these shares pursuant to our announcement on March 7, 2007 that we will purchase up to 500,000 shares of our Class A common stock at market prices prevailing from time to time in

the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We may purchase up to 5,231 additional shares of our Class A common stock under this stock repurchase program. We announced on February 23, 2009 that we will purchase up to 300,000 shares of our Class A common stock at market prices prevailing from time to time in the open market subject to the provisions of SEC Rule 10b-18 and in privately negotiated transactions. We have not purchased any shares under this stock repurchase program during the period.

Item 3. Defaults upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

We held our annual meeting of stockholders on April 16, 2009 (the Meeting), with the following results:

The total number of votes represented at the Meeting in person or by proxy was 7,466,068 of the 7,563,682 votes for holders of common stock outstanding and entitled to vote at the Meeting.

On the resolution to elect Jon M. Mahan, Donald H. Nikolaus and Richard D. Wampler, II as Class B Directors to serve until the expiration of their respective terms and until their successors are duly elected, the nominees for director received the number of votes set forth opposite their respective names below:

	Number of Votes	
	For	Withheld
Jon M. Mahan	7,372,503	93,565
Donald H. Nikolaus	7,368,104	97,964
Richard D. Wampler, II	7,372,388	93,680

There were no abstentions or broker non-votes. On the basis of the above vote, Jon M. Mahan, Donald H. Nikolaus and Richard D. Wampler, II were elected as Class B Directors to serve until the expiration of their respective terms and until their successors are duly elected.

On the resolution to ratify our Audit Committee s selection of KPMG, LLP as our independent registered public accounting firm for 2009, the resolution received 7,419,430 votes for the resolution, and 46,638 votes were withheld. On the basis of this vote, our stockholders ratified the Audit Committee s selection of KPMG, LLP.

Item 5. Other Information.

None.

Item 6. Exhibits.

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

Signatures

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

	DONEGAL GROUP INC.
August 7, 2009	**By:** /s/ Donald H. Nikolaus Donald H. Nikolaus, President and Chief Executive Officer
August 7, 2009	**By:** /s/ Jeffrey D. Miller Jeffrey D. Miller, Senior Vice President and Chief Financial Officer