

**SAUCON MUTUAL INSURANCE COMPANY**  
**SEPTEMBER 1, 2015 INFORMATIONAL HEARING ON PLAN OF CONVERSION**  
**WRITTEN TESTIMONY**  
**OF**  
**BRIAN REGAN**

**Introduction**

I am Brian Regan, President and Chair of the Board of Saucon Mutual Insurance Company and a shareholder of Regan, Levin, Bloss, Brown and Savchak, an accounting firm with offices in Allentown, Easton and Stroudsburg, Pennsylvania. I have been a member of the Board of Saucon Mutual for 11 years. In my position at Saucon Mutual, I have been integrally involved, along with other members of the Board and management of Saucon Mutual and Saucon Mutual's outside consultants, in the deliberations, evaluations and decisions that went into a determination to propose and adopt a Plan of Conversion to be filed with the Pennsylvania Insurance Department and presented to Saucon Mutual's members.

We would like to thank Deputy Commissioner Johnson and other members of the Pennsylvania Insurance Department for scheduling this hearing, and for the substantial efforts the Department has made in its consideration of the proposed conversion of Saucon Mutual from a mutual insurance company to a stock insurance company.

**Purpose of Presentations & Testimony**

The Department has received and reviewed a substantial amount of information relating to our proposed Conversion transaction, and my testimony as well as that of others on behalf of Saucon Mutual is not intended to reiterate all of the information that is already in the public record and posted on the Department's website. However, I do want to briefly provide information on Saucon Mutual – our history and what we do – as well as a brief summary of our proposed Conversion, including what our Board considered in deciding to pursue a conversion, what the Conversion means to our members, and what our future plans are for the Company if the Conversion is approved by both the Department and our members.

In addition to my written testimony, there is written testimony by Stephen Bajan, Saucon Mutual's Chief Executive Officer, and Anthony Latini of Boenning & Scattergood, a consultant

to the Saucon Mutual Board who, beginning in 2012, assisted us evaluating options to meet our objectives for the Company, including consideration of pursuing a conversion and evaluating past mutual insurer conversions in Pennsylvania and the pros and cons of the various available types of conversions to both the Company and our policyholders. Boenning & Scattergood also provided the Fairness Opinion on the Conversion that is posted on the Department's website.

### **History of Saucon Mutual**

Before providing information on our proposed Conversion, I would like to briefly describe the history of Saucon Mutual – who we are and what we do. Saucon Mutual began business in 1832 and has operated as a property insurance company for over 180 years. Saucon is approved to write homeowners and dwelling property coverages in Pennsylvania, and has written primarily perpetual and a few term policies under these programs. As of August 27, 2014, the date of the Board's adoption of the Plan of Conversion (the "Record Date"), Saucon Mutual had 394 in force policies – 369 perpetual policies and 25 term policies.

Perpetual policies are a unique product. To our knowledge, we are only one of three existing insurers in Pennsylvania that have written perpetual policies. Our decision to cease offering new perpetual policies in 2005 was based on the nature of perpetual policies, where – in lieu of annual premium payments – the policyholder makes one up-front payment (the deposit) and then no further payments throughout the life of the policy unless there is an increase in or addition of coverage. Upon termination of a perpetual policy, the deposit is returned in full to the policyholder. Because policyholder deposits are returnable at the end of the policy, they are treated as liabilities of the Company. Accordingly, the only source of revenue to pay claims and administrative costs under perpetual policies is the investment return on policyholder deposits. Accordingly, Saucon Mutual found – as have other insurers that have offered perpetual coverage – that it is difficult to maintain financial viability in a low interest rate environment. As a result, Saucon Mutual has not written any new perpetual insurance policies since December 2005 and has written only a very limited number of term policies since that time.

Due to its decision to cease writing new perpetual policies, Saucon Mutual has had very limited insurance operations since 2005 and, consequently, has maintained minimal infrastructure and staffing for insurance operations (Saucon Mutual has only 3 staff members who also perform duties for Saucon Mutual's wholly owned subsidiary, Saucon Insurance

Agency (an entity formed as a low-risk means to maintain activity in the insurance arena)). Although Saucon Mutual has maintained a level of surplus that satisfies relevant legal requirements, the current lack of adequate staff and infrastructure to successfully resume the underwriting of new insurance policies was an important consideration by the Board in how to meet its objective of re-entering the insurance underwriting business.

### **Saucon Mutual's Policyholders**

Stephen Bajan's written testimony provides information on Saucon Mutual's current policyholders and additional detail on how perpetual policies differ from term policies.

### **Overview of the Proposed Conversion**

Saucon Mutual's Board began discussions in 2012 with its outside consultants (Anthony Latini of Boenning & Scattergood and Constance Foster of Saul Ewing LLP) on available alternatives to re-enter the insurance underwriting business and to support such operations by modernizing the corporate structure and building necessary infrastructure and staffing.

Because of the limited means by which mutual insurers can raise funds for operations (contributions, loans or merging with another mutual insurer) as compared to stock insurers, the Board, with the assistance of its outside consultants, began to explore the concept of converting Saucon Mutual to a stock insurance company. In doing so, and as set forth in the materials filed with the Department and publicly available on the Department's website, the Board established the following objectives for such a conversion: (i) rewarding Saucon Mutual members for their loyalty to the Company; (ii) making a charitable contribution in furtherance of the Company's ongoing commitment to the community (including people who once were, but no longer are, policyholders of Saucon Mutual and, thus, would not receive direct compensation under a conversion); (iii) modernizing the Company's governance structure; (iv) enabling the issuance of stock and other financial instruments in order to raise capital, to facilitate potential acquisitions of other businesses, and to incentivize employees; (v) preparing the Company to re-enter the insurance underwriting business; and (vi) maintaining the independence of the Company.

In consideration of its objectives, the Board examined other mutual-to-stock conversions in Pennsylvania under the various alternatives for mutual insurer conversions in Pennsylvania law, including:

- Subscription rights conversions (where, in exchange for the extinguishment of their membership rights in the mutual insurer, members of the mutual insurer (i.e. its policyholders) are given the right to purchase stock in the converted insurer and, if there is insufficient member interest in the purchase of such stock, the right to purchase is opened to others);
- Mutual holding company conversions (where a mutual holding company is formed with members of the mutual insurer obtaining “mutual rights” in the mutual holding company and their rights under the insurance contract remaining with the converted insurance company; and, in some mutual holding company conversions, where a stock holding company is formed in between the mutual holding company and the converted insurance company, and capital is raised for the stock holding company directly and the converting insurer indirectly by giving members and others the right to purchase stock in the stock holding company); and
- Alternative conversions (where, typically, members receive consideration for the extinguishment of their membership rights in the form of cash or coverage benefits, e.g. a specified amount of coverage at no cost for a specified period of time).

In its examination and evaluation of prior conversions, the Board observed that, in prior subscription rights conversions and mutual holding company conversions that provided subscription rights in a stock holding company, very few members of the mutual insurers chose to purchase stock in the converting insurer or the stock holding company (possibly because of a lack of ability or desire to invest in such stock and/or, while the purchase of stock allows for the acquisition of an asset, it may be illiquid to the member and of no immediate value). In addition, for mutual holding company conversions where the sole consideration is membership rights in the mutual holding company, there is nothing of immediate value given to the mutual insurer’s members in consideration for extinguishment of their membership rights in the converting insurer. The Board also observed that mutual holding company conversions raise no capital unless the “second step,” a stock holding company, is formed; that prior mutual holding company conversions resulted in subsequent conversion of the mutual holding company; and that few mutual holding company conversions have been pursued in recent years due to adverse litigation in prior conversions, the significant cost and timeframe for the two-step process, and the resulting policyholder confusion.

After consideration of the available options for converting to a stock insurer, Saucon Mutual's Board determined that its objectives were best met via an alternative conversion that included the following four elements:

1. Loyalty payment to Saucon Mutual members upon conversion in consideration for the extinguishment of their membership rights.
2. Charitable contribution in furtherance of the Company's ongoing commitment to the community.
3. Formation of a new stock holding company (Saucon Holding Company) that would, through purchase of stock of the converted Saucon Mutual (Saucon Insurance Company), become the sole shareholder of the Saucon Insurance Company.
4. A stock offering of Saucon Holding Company stock to members of Saucon Mutual's Board and management in order to raise funds for the purchase of the converted Saucon Mutual's stock (in an amount to assure that there would be no adverse impact on the surplus of the converted insurer as a result of the Conversion and the loyalty payments to members), with the remainder to be utilized to pay the costs/expenses of the Conversion and the related transactions and as a cash reserve for the future investment and needs of the Holding Company and Saucon Insurance Company.

Representatives of the Board and its consultants had two meetings with the Department, first to discuss alternative plan conversions in general, its objectives in a conversion and why Saucon Mutual believed it was the best alternative. The second meeting, in June of 2014, was to respond to questions raised by the Department in the prior meeting and to share the details of the proposed Conversion, including the amount and form of member consideration, and the future plans of the Company.

Saucon Mutual's Board then adopted a Plan of Conversion on August 27, 2014 (the "Record Date") and on September 2, 2014 made a filing with the Department for its approval of (1) the Plan of Conversion and (2) a Form A (Acquisition of Control) Statement for the Saucon Holding Company's purchase of stock of Saucon Insurance Company and for the three individuals who are current Board members of Saucon Mutual (myself, Michael Crofton and Martin Gilchrist) who wish to purchase stock of Saucon Holding Company that would result in each of us having a 10% or greater voting ownership of Saucon Holding Company. Shortly after the filing, Saucon Mutual sent a notice to all of its members advising of the filing, the

Department published notice in the Pennsylvania Bulletin to advise of the filing and invite written comments to the Department on the filing, and the Department posted on its website all of the nonconfidential documents included in the filing.

After the filing of its initial Conversion documents and subsequent discussions with the Department, Saucon Mutual made several revisions to its proposed Plan of Conversion (again, these revisions are posted on the Department's website). Saucon Mutual's Board believes that its adopted Plan of Conversion meets both the requirements and standards of Pennsylvania law as well as its objectives described above in the following ways:

- Rewarding Members for their Loyalty to the Company. The consideration that members of Saucon Mutual as of the Record Date would receive upon the closing of the Conversion would depend, in part, upon the number of years that the member's policy had remained in force as well as the premium or deposit paid by the member (Stephen Bajan discusses the consideration in more detail in his written testimony). This permits Saucon Mutual to reward members for their loyalty to the Company in maintaining their policies. The aggregate amount of the payments to members was estimated to be approximately \$1,564,839 (assuming a July 31, 2015 closing date) and will be slightly higher with a later closing date. Further, the aggregate value of consideration to perpetual policyholders, not in the form of cash payments, is approximately \$500,000 higher as described in Stephen Bajan's written testimony. Compared to other alternative conversions where the consideration to members was generally only in the form of a specified amount of coverage at no cost to the member, which, due to the nature of Saucon Mutual's perpetual policies, would be meaningless, the Board determined that the combination of cash and coverage benefits would provide value to the policyholders. Further, the Board felt that the provision of immediate consideration to its members was preferable to a subscription rights conversion where the option to purchase stock of the converted insurer or its holding company may provide "value on the books" of a member if the member chose to or had the funds to purchase stock, but may be an essentially illiquid asset of the member and of no immediate value if there is no interest in purchasing the stock, and, thus, most likely result in the vast majority of members receiving no consideration.

- Making a charitable contribution in furtherance of the Company’s ongoing commitment to the community. Upon the closing of the Conversion, the Company would make a \$500,000 cash contribution to the Lehigh Valley Community Foundation, a public charitable organization operating since 1967 for the purposes of stewarding philanthropic resources from institutional and individual donors to community-based organizations to serve the Lehigh Valley. The contributions committee of Saucon Insurance Company’s board of directors will then make recommendations as to how those funds should be disbursed by the Foundation for charitable purposes. The members of the contribution committee will not be compensated for their service on the committee. In addition, the Company has committed to making additional charitable contributions to the Foundation of \$100,000 per year for 5 consecutive calendar years beginning with the first full calendar year after closing of the Conversion. As mentioned above, the Board believes that such a charitable contribution will benefit not only the community in general, but also people in the community who once were, but no longer are, policyholders of Saucon and, thus, will not receive direct compensation in the Conversion.
- Enabling the Issuance of Stock and Other Financial Instruments in order to Raise Capital, to Facilitate Potential Acquisitions of Other Businesses, and to Incentivize Employees. A mutual company cannot issue stock. A stock corporation, on the other hand, can issue shares of its stock and other financial instruments. Among the reasons that a stock corporation may issue shares of stock or other financial instruments are:
  1. To sell the shares to investors to raise capital for the company;
  2. To acquire another business, by using the stock or other financial instruments that it issues as some or all of the purchase price for the business; and
  3. To incentivize employees through the issuance of stock grants, stock options and other similar equity compensation strategies, because those strategies can give the employees who receive those grants the opportunity to share in the economic benefits of the growth of the company. This can help the company attract and retain suitable employees.
- Re-entering the Insurance Underwriting Business. While Saucon Mutual is in a stable position from a financial point of view, it has written very few new insurance policies since 2005. Saucon Mutual’s personnel and business systems are adequate to continue to

maintain the existing insurance policies and their renewals in full force and effect, but it does not presently have sufficient personnel and infrastructure to enable it to issue new insurance policies. The Board believes that converting the Company to a stock insurer would permit the Company to implement steps to attract and retain suitable personnel and to develop appropriate infrastructure to assist the Company in re-entering the business of underwriting new insurance. Indeed, upon closing of the Conversion, the Company will begin work on developing infrastructure for underwriting insurance, including systems, claims, underwriting, documentation, and development of a distribution network. While this infrastructure is being developed, the Company intends to re-enter insurance underwriting in an indirect and measured way by initially exploring reinsurance opportunities where Saucon would be the quota share reinsurer of compatible products of another insurer. The Company has already conducted research of the market and believes there is an unmet need for additional capacity for property insurance for churches, which is a market to which Saucon feels a certain affiliation because of its Moravian roots.

- Maintaining the Independence of the Company. Upon the closing of the Conversion, Saucon Insurance Company will become a wholly-owned subsidiary of Saucon Holding Company. The stock of Saucon Holding Company in turn will be purchased by investors in a concurrent stock offering. The investors in that stock offering are individuals who are Board members or members of management of Saucon Mutual, rather than being other persons or entities, including other insurance companies, thus, maintaining the independence of the Company. The stock offering is expected to raise a total of \$3,250,000, of which \$1,425,000 will be utilized to purchase the stock of Saucon Insurance Company with the remainder being utilized to pay the costs and expenses of the Conversion and the related transactions and as a cash reserve for future investments and needs of both Saucon Holding Company and Saucon Insurance Company.
- Modernizing the Company's Governance Structure. The Board believes that it is in the Company's interest to align the interests of its constituents with the growth and success of the Company, and that organization as a stock corporation via the Conversion is a more appropriate structure to accomplish this goal than as a mutual company. For example, the authority to elect directors and make certain other decisions with respect to a Pennsylvania mutual insurance company such as Saucon Mutual lies with its members

(i.e., its policyholders). But each member is entitled to cast one vote — regardless of the type of policy or the amount of coverage — with respect to a matter that is submitted to the members for approval, which means that there is no particular relationship between a particular member’s commercial relationship with the Company and the weight of that member’s vote. By way of contrast, in the case of a stock corporation, each stockholder is entitled to cast one vote per share, which means that a stockholder who wishes to enjoy a greater degree of control over the corporation can do so by acquiring more shares. The Board believes that it is in the Company’s interest to adopt a governance structure where the voting power of a constituent of the Company is more closely aligned to that constituent’s economic interest in the Company, as represented by that constituent’s investment in the Company to acquire shares.

#### **Next Steps If Approved by the Department**

As indicated in the Notice of Hearing published in the Pennsylvania Bulletin and provided by Saucon Mutual to its members, the hearing conducted by the Department provides an additional opportunity for members and others to comment on the proposed Conversion — either in person at the hearing or by submitting written comments to the Department. Indeed, since the Notice was published and mailed to members, a written inquiry was submitted to the Department and forwarded to Saucon Mutual for response. This inquiry was from a current perpetual policyholder and asked about the effects of the Conversion on the member’s policyholder status, any changes to premium and other changes to the member’s relationship to the Company after implementation of the Conversion. As set forth in Saucon Mutual’s response to the inquiry (both the inquiry and response are posted on the Department’s website), while the policyholder’s membership rights (e.g. voting rights to elect directors and approve a conversion) would be extinguished upon the effective date of the Conversion and for which the policyholder would receive consideration as described in Stephen Bajan’s written testimony, there would be no changes to the policyholder relationship with the Company.

If, after evaluation of Saucon Mutual’s filing and comments made at the hearing or otherwise submitted to the Department, the Department approves Saucon Mutual’s Conversion, following are additional steps that are required before the Conversion may be implemented:

- Saucon Mutual will mail to its members as of the Record Date a Member Information Statement and Proxy Statement advising of a Special Meeting of Members to vote on the Conversion (the documents that will be mailed are on the Department's website). As required under Pennsylvania law, the Conversion may be effected only if it is approved by an affirmative vote, in present or by proxy, of at least two-thirds of the members that are cast at this Special Meeting of Members, if a quorum is present.
- If the Conversion is approved by members at the Special Meeting of Members, Saucon Mutual will then be converted to a stock insurer (Saucon Insurance Company). Saucon Insurance Company will then issue checks to its eligible policyholders for the consideration described in detail in the written testimony of Stephen Bajan. At the same time, the investors in the stock offering for Saucon Holding Company will purchase their stock and Saucon Holding Company will purchase the stock of Saucon Insurance Company.

#### **Consideration to be Paid to Perpetual & Term Policyholders in the Conversion**

Stephen Bajan's written testimony describes in detail the consideration to be paid to each of Saucon Mutual's perpetual policyholders and term policyholders as of the Record Date.

#### **Conclusion**

In closing and as indicated above, we believe that Saucon Mutual's Board undertook a thorough and deliberative process in making the determination to propose a conversion of Saucon Mutual to a stock insurance company and with the elements of the proposed Conversion. Further, we believe that the Board adopted a Plan of Conversion that meets both the requirements and standards of Pennsylvania law as well as the Board's objectives for the Company as described above.