

JAN - 7 2009

Hearings Unit, OIC
Patricia D. Petersen
Chief Hearing Officer

**BEFORE THE STATE OF WASHINGTON
OFFICE OF INSURANCE COMMISSIONER**

In the Matter of the)
Proposed Acquisition and Control of:)
)
NATIONAL MERIT INSURANCE)
COMPANY, a Washington domiciled)
property and casualty insurer and subsidiary)
of **DIRECT RESPONSE CORPORATION**,)
by)
TRINITY UNIVERSAL INSURANCE)
COMPANY,)
)

Applicant.)

NO. G08-0182

**DECLARATION OF
DAVID F. BENGSTON**

DAVID F. BENGSTON, under penalty of perjury under the laws of the State of Washington,
declares as follows:

1. I am a Vice President of Unitrin, Inc. I am over the age of eighteen years old, and I make this Declaration based upon personal knowledge.

2. Attached hereto is a true and correct copy of my Pre-filed Direct Testimony in the above-referenced matter. I am competent to testify in the matters set forth in my testimony, and I incorporate the contents of my Pre-filed Direct Testimony into this Declaration.

Signed this 7th day of January, 2009, at Chicago, Illinois.



David F. Bengston

Company, a Washington property and casualty insurer. For convenience I will refer to those two entities as DRC and National Merit, respectively.

Through its acquisition of DRC, Trinity would acquire control of National Merit and various other operating insurance company subsidiaries of DRC domiciled in states other than Washington. Through its ownership of Trinity, Unitrin would be the ultimate controlling person of National Merit following Trinity's acquisition of DRC. In light of this proposed acquisition, Trinity filed a Form A Statement seeking the approval of its acquisition of control over National Merit with the Washington State Office of the Insurance Commissioner, and I am here today to testify in support of that Form A Statement.

3. Q: How long have you been employed by Unitrin?

A: I have been employed by Unitrin since May of 1978, when I was hired as Manager of Internal Audit for United Insurance Company of America, a subsidiary of Unitrin. I have held a variety of positions since then culminating in my current position as a Vice-President of Unitrin and a Director of Trinity.

4. Q: Do you currently hold any other professional titles, positions or designations?

A: I hold the designations of Certified Public Accountant and Fellow, Life Management Institute.

5. **Q: Please describe your educational background.**

A: I earned my Bachelor's degree from Northern Illinois University.

6. **Q: Have you been authorized by Unitrin and Trinity to speak on their behalf at this Form A hearing?**

A: Yes, I have been authorized to speak on behalf of Unitrin in my capacity as Vice President and on behalf of Trinity in my capacity as a Director.

7. **Q: Could you give us a brief description of your involvement and role in the proposed transaction and the basis for your information and knowledge of the proposed transaction described in the Form A Statement?**

A: In my current position for Unitrin I am involved in various corporate development projects which include the acquisition of DRC. With respect to the DRC acquisition, I personally reviewed and commented on various drafts of the Stock Purchase Agreement and the corresponding Form A filings and I was consulted by our business personnel and our legal counsel on various issues related to the deal negotiations and regulatory filings as and when matters developed, and I generally have been involved in and have personal knowledge of Unitrin's and Trinity's internal business considerations and planning in connection with this transaction.

8. **Q: As part of your involvement with this proposed transaction, did you have occasion to review the Form A Statement that is the subject of this proceeding and the supplemental materials provided to the Washington State Office of the Insurance Commissioner, and if so, do you believe that the Form A Statement and the supplemental materials provided to the Office are complete, true and current in all material respects?**

A: Yes, I personally reviewed the Form A Statement and the supplemental materials and correspondence provided to the Washington State Office of Insurance Commissioner and I believe those materials are complete, true and current in all material respects. For convenience, throughout my testimony I will refer to the Washington State Office of Insurance Commissioner as OIC and I will refer to the Form A Statement and the supplemental materials and correspondence provided to OIC as the Application.

9. **Q: Have there been any material changes with respect to the information contained in the Application?**

A: To the best of my knowledge, there have been no material changes with respect to the information contained in the Application.

10. **Q: Were DRC and National Merit provided a copy of the Application?**

A: Yes. Susan Claflin was provided a copy of the Application on behalf of DRC

and National Merit in her capacity as a Director, General Counsel and Secretary for both entities.

B. Overview of the Proposed Acquisition

1. Q: Can you briefly describe Unitrin and its business?

A: Unitrin is a diversified financial services holding company with subsidiaries engaged in the property and casualty insurance, life and health insurance and automobile finance businesses. Unitrin is a publicly held company, traded on the New York Stock Exchange under the trading symbol UTR. As of September 30, 2008, Unitrin reported total assets of \$9.2 billion and shareholders' equity of \$1.8 billion. Of the total revenues of \$2.1 billion that Unitrin reported in the first nine months of 2008, nearly \$1.8 billion pertained to insurance premiums of which approximately \$1.3 billion, or 72.8%, represents personal lines property and casualty premium revenues, primarily auto and homeowners business. Also as of September 30, 2008, Trinity reported statutory basis admitted assets of \$2.9 billion and total surplus of \$891 million. Jim Schulte will describe Unitrin's property and casualty businesses in more detail during his testimony. In addition, Unitrin and its subsidiaries have approximately 7,700 employees.

2. Q: Can you explain briefly Unitrin's involvement in the acquisition of the Domestic Insurer?

A: Unitrin is the direct parent company of Trinity. Trinity intends to acquire all of the issued and outstanding common stock of DRC from the selling shareholders, as follows: Morgan Stanley Capital Partners III, L.P., MSCP III 892

Investors, L.P., Morgan Stanley Capital Investors, L.P., DR Investors, L.P., DR Investors II, L.P., James M. Stone, The Plymouth Rock Company Incorporated, and Mory Katz (collectively, the "Selling Shareholders"). There are no other shareholders of DRC other than those I just referred to, who collectively own all of the issued and outstanding shares of DRC stock. National Merit is a wholly-owned subsidiary of DRC, and thus as a result of acquiring the shares of DRC Trinity will acquire control of National Merit.

After Trinity acquires all of the issued and outstanding shares of DRC, DRC will continue to own one hundred percent (100%) of the issued and outstanding shares of stock of National Merit, and Trinity will own one hundred percent (100%) of the issued and outstanding shares of stock of DRC. Thus, Trinity will indirectly own and control National Merit by virtue of its ownership of 100% of DRC's stock. Moreover, after Trinity acquires the DRC shares, Unitrin will continue to own one hundred percent (100%) of the issued and outstanding stock of Trinity and thus Unitrin will be the ultimate controlling person of National Merit by virtue of its ownership and control of Trinity.

3. Q: Can you summarize the details of the transaction?

A: The specific terms and conditions governing the transaction are set forth in the Stock Purchase Agreement dated as of August 29, 2008 between Trinity, on the one hand, and the selling shareholders, on the other hand. For convenience, throughout my testimony I will refer to the Stock Purchase Agreement as the

SPA. But I can summarize the material terms of the SPA and the transactions it contemplates by discussing nine basic components of the deal:

- First, at the closing of the transaction, Trinity will acquire from the selling shareholders 266,460.58350 shares of common stock of DRC, representing all of the issued and outstanding stock of DRC, and thereby acquire control of the Domestic Insurer.
- Second, as consideration for acquiring the DRC shares, Trinity will pay to the selling shareholders an aggregate cash purchase price of Two Hundred Twenty Million Dollars (\$220,000,000), which I will refer to as the Base Price, plus or minus, as the case may be, certain adjustments relating to (1) the after-tax appreciation or depreciation of the securities portfolio owned by DRC and its subsidiaries, and (2) the consolidated GAAP net after-tax income or loss of DRC and its subsidiaries, in each case for the period from January 1, 2008 through a date determined in accordance with the terms of the SPA, which I will refer to as the Base Date. For convenience, I will refer to the aggregate cash purchase price to be paid by Trinity, which is simply the Base Price as adjusted by the factors I just described, as the Purchase Price.
- Third, the Purchase Price will be paid in cash from Trinity's internal resources. Trinity sold equity securities generating cash proceeds of \$343 million during the month of October, 2008. Trinity plans to use these

proceeds to fund the acquisition. Trinity does not anticipate borrowing any funds to pay the Purchase Price.

- Fourth, at closing, Trinity will pay the Purchase Price to the selling shareholders, with two exceptions. The first exception is that Trinity will hold back Fifteen Million Dollars (\$15,000,000) and instead deposit those funds into an escrow account as security for the selling shareholders' post-closing indemnification obligations, as well as Trinity's rights under the SPA to be compensated for potential adverse reserve development, something I will talk about in a moment. The second exception is that a portion of the Purchase Price, an amount equal to the consideration required to cancel and terminate certain stock option agreements referenced in the SPA and the stock options granted thereunder pursuant to DRC's 2004 Management Equity Plan, will be paid to DRC instead of the selling shareholders and DRC will use those funds to pay the consideration necessary to cancel and terminate those option agreements.
- Fifth, to the extent there is favorable or adverse development reflected in the closing date reserves – as such reserves are defined in Annex G of the SPA – and to the extent that favorable or adverse loss development exceeds One Million Dollars (\$1,000,000), Trinity agrees to pay the selling shareholders 75% of any such favorable development, and the selling shareholders agree to pay Trinity 75% of any such adverse

development out of the escrow account, as the case may be, and in each case up to a maximum payment of Fifteen Million Dollars (\$15,000,000).

- Sixth, Trinity agreed to retain as employees for a period of at least twelve (12) months following the closing no less than sixty percent (60%) of the individuals who are employed by DRC and its subsidiaries as of the closing date.
- Seventh, the SPA contains various representations and warranties by the parties, and imposes certain other pre-closing covenants and post-closing indemnification obligations on the parties, in each case that are either customary for acquisitions of this nature or otherwise suitable for this particular transaction.
- Eighth, the closing of the transaction is subject to closing conditions that are either customary for acquisitions of this nature or otherwise suitable for this particular transaction, including, without limitation, conditions relating to the receipt of regulatory approvals, accuracy at the closing date of representations and warranties made in the Agreement, compliance with pre-closing covenants and delivery of closing documentation.
- Ninth, and finally, the closing of the Transaction will take place on a date following the date on which all closing conditions have been satisfied or waived, including, without limitation, the receipt of all regulatory approvals.

4. **Q: How was the Base Price and the nature and amount of the Purchase Price for the DRC shares determined?**

A: The Base Price was determined by using a discounted cash flow approach to valuation, which I will refer to as the DCF Model. The DCF model valued DRC as the value of DRC's operations plus the tangible book value as of December 31, 2007, minus the amount of required statutory surplus necessary to support operations. The value of DRC's operations equals the discounted value of expected future statutory earnings including investment income on required statutory surplus. Note, however, that we did not price individual entities such as National Merit, but rather priced DRC's operations as a whole and on a consolidated basis.

I also should point out that the nature and amount of the Purchase Price for the DRC shares that was ultimately agreed to was determined by arm's length negotiations between the respective parties. In determining the amount of cash to be paid for the DRC shares, Trinity considered the business that DRC and its subsidiaries are authorized to transact, their past and current business operations, historical and potential earnings, financial condition and prospects, assets and liabilities, and such other factors and information as Trinity considered relevant under the circumstances.

C. Corporate and Regulatory Approvals

1. Q: Was this transaction approved by Unitrin's shareholders?

A: No. There are no requirements for approval by Unitrin's shareholders of a transaction of this size and nature by a Unitrin subsidiary contained in either Unitrin's corporate articles or bylaws or the various federal and state laws applicable to Unitrin. Unitrin did, however, seek and obtain the approval of its board of directors for this proposed transaction.

2. Q: Was this transaction approved by Trinity's Board of Directors or shareholders?

A: Yes, Trinity sought and obtained the approval of its board of directors for this proposed acquisition.

3. Q: Is this transaction subject to regulatory approval by any governmental agencies other than OIC?

A: Yes. There was one federal regulatory filing and approval required as a result of this transaction and several other state regulatory filings and approvals required.

First, the transaction was large enough to trigger the waiting period and review requirements under the federal Hart-Scott-Rodino Antitrust Improvements Act of

1976. To that end Trinity made the requisite filings with the Federal Trade Commission and sought and obtained from the Commission early termination of the required waiting period on September 26, 2008.

Second, as a result of acquiring DRC's shares, Trinity will also acquire control of other insurance company subsidiaries that are domiciled in states other than Washington; specifically, the states of California, Connecticut and New York. To that end, Trinity filed Form A Statements in each of those three states roughly on or around the same time it filed its Form A Statement in Washington. I can report that Connecticut approved the proposed acquisition on December 12, 2008, following a public hearing. Connecticut is the state where DRC is headquartered and where most of the insurance companies being acquired are domiciled. California approved the proposed acquisition on December 29, 2008. There was no public hearing required or conducted in California for this acquisition. To date, I can also report that we have responded to every supplemental inquiry of the New York Superintendent of Insurance, none of which raised any substantive objections or issues with the proposed acquisition, and we hope and anticipate receiving New York's approval soon. There was also no public hearing conducted or required in New York for this acquisition.

D. Statutory Standards of Review

1. **Q: Are you familiar with the statutory requirements with which any proposed acquisition of control transaction must comply before the Commissioner can approve any such transaction, as set forth in Section 48.31B.015 of the Washington Insurance Code?**

A: Yes, I am familiar with the standards of review as set forth in Section 48.31B.015 of the Washington Insurance Code. I understand Jim Schulte of Trinity will be testifying shortly in more detail on each of those criteria. But I will add that, based upon the information contained in my testimony, in the Application, and in the Pre-filed Direct Testimony of James A. Schulte, which I reviewed and concur with completely, and also based on my general personal knowledge of the transaction, I believe the proposed acquisition meets the statutory standards for approval.

E. Miscellaneous

1. **Q: Is there anything else that you would like to add at this time about the transaction itself?**

A: Yes. You will recall that I previously described an adjustment feature contained in the Purchase Price provisions of the SPA, through which the Base Price is adjusted upward or downward based upon relative fluctuations in DRC's investment portfolio and operational net income or loss. There are perhaps two other things I should say about that.

The first is that the rationale for having this feature in the SPA is simply to reflect the fact that the Base Price was determined based on the financial status of DRC at a snapshot in time – in this case as at December 31, 2007 – and thus the parties agreed that the Base Price would be adjusted to reflect, at least in part, the subsequent financial results of DRC following that snapshot in time, although the parties have essentially agreed to split the impact of those upward or downward adjustments, as the case may be, between them equally.

The second is that as a result of this adjustment mechanism in the Purchase Price, the Purchase Price remains subject to change if and as the closing of the transaction is delayed, and so both sides of the transaction have an interest in completing the transaction as expeditiously as possible.

2. Q: Is there anything else you would like to add at this time about Unitrin and Trinity?

Yes. One thing that I think worth mentioning, particularly in the current economic environment, is the financial strength and conservative financial approach that Unitrin and Trinity bring to the table for DRC and its operating insurance subsidiaries, including National Merit. For example, Trinity is funding the entire Purchase Price with its own existing cash resources and is not incurring any debt to pay for this acquisition. Moreover, Unitrin and Trinity currently enjoy strong financial strength ratings with all of the major ratings agencies. Unitrin and Trinity maintained a conservative capital management and

investment philosophy before the current economic crisis and thus managed to avoid the catastrophic economic losses that some insurance organizations with less conservative capital management and investment philosophies have experienced. Moreover, as the economic crisis has unfolded, Unitrin and Trinity have put enhanced procedures in place to determine and monitor Trinity's capital position on a daily basis, and they have taken an even more conservative approach to their investment portfolio and have sold or otherwise divested themselves of various assets that were no longer consistent with this more conservative approach, and there are covenants contained in the SPA that essentially require DRC and its operating companies to similarly divest themselves from certain alternative assets that were not consistent with Unitrin's and Trinity's investment approach. In short, I believe the financial strength and conservative capital management and investment philosophies of Unitrin and Trinity will serve the policyholders of National Merit and the citizens of the State of Washington very well during the challenging economic times we are currently experiencing.

Finally, on behalf of all of us at Unitrin and Trinity, I would like to thank the OIC and Judge Peterson for their prompt attention to this matter and for their professionalism and diligence in reviewing Trinity's Application. I look forward to continuing to work with the OIC following the completion of the proposed acquisition.

Verification

I, David F. Bengston, declare under penalty of perjury of the laws of the State of Washington that the foregoing answers are true and correct.

Dated this 7th day of January, 2009, at Chicago, Illinois.



David F. Bengston
Vice President, Unitrin, Inc.
Director, Trinity Universal Insurance Company