STATE OF NEW HAMPSHIRE
DEPARTMENT OF STATE
BUREAU OF SECURITIES REGULATION

IN THE MATTER OF:	)	
Local Government Center, Inc., et al.	)	Case No: C-2011000036

RESPONDENTS' TRIAL BRIEF

Respondents, by and through counsel, submit this Trial Brief.

INTRODUCTION

This is an administrative proceeding to enforce RSA Ch. 5-B and RSA Ch. 421-B. The Bureau of Securities Regulation ("BSR") commenced this proceeding by filing a Staff Petition on September 2, 2011. It subsequently filed an Amended Petition on February 17, 2012. The BSR has alleged, inter alia, that Respondents violated their fiduciary duties. Respondents submit this brief to detail the standards that apply to allegations of a breach of fiduciary duty.

ARGUMENT

A. Legal Framework

Directors' fiduciary duties are defined by law. Under New Hampshire law, each director is obligated to discharge his or her duties (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he or she reasonably believes to be in the best interests of the organization. RSA 293-A:8.30(a). In discharging these duties, a director is "entitled to rely on information, opinions, reports, or statements" prepared by employees, legal counsel, public accountants, and other board members or committees, provided that the director reasonably believes the person presenting the information is competent to present that information. RSA 293-A:8.30(b). Finally, "[a] director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section." RSA 293-A:8.30(d).

As with the corporate laws of other American states, the New Hampshire statutes strike a careful balance: they impose certain obligations on directors as to the procedure they must follow and the perspective they must maintain towards their duties as directors, but also provide that there is no violation of fiduciary duty when a director fulfills these obligations, including when he or she acts in reasonable reliance on expert advice.

As the New Hampshire statutes make clear, and the Delaware Supreme Court has explained, "[t]he ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors." *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986).[1] While directors have "an unyielding fiduciary duty to protect the interests of the corporation," *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (1993), courts are reluctant to second guess their judgment in doing so, provided they are acting, as New Hampshire law provides, (1) in good faith; (2) with due care; and (3) in a manner reasonably believed to be in the organization's best interests, *see* RSA 293-A:8.30(a), (d).

In order to simultaneously effectuate these potentially competing principles—that directors have managerial prerogatives to run the organization but also must act as fiduciaries in discharging their responsibilities—common law courts have formulated the *business judgment rule*, which "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation." *Cede & Co.*, 634 A.2d at 360. "The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an

[1] Although New Hampshire courts have not extensively explored the extent and limits of a director's duties, Delaware courts have done so in exhausting detail, and state and federal courts from around the country look to Delaware caselaw to guide legal interpretation of the meaning and extent of a director's fiduciary duties.

informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1373 (Del. 1995) (internal quotation marks omitted).

The business judgment rule "posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose." *Cede & Co.*, 634 A.2d at 361 (internal quotation marks omitted). The business judgment rule has both procedural and substantive components:

> The business judgment rule operates as both a procedural guide for litigants and a substantive rule of law. Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the … plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any one of its triad of fiduciary duties, loyalty, good faith or due care. Substantively, if the … plaintiff fails to meet that evidentiary burden, the business judgment rule attaches and operates to protect the individual director-defendants from personal liability for making the board decision at issue.

McMullin v. Beran, 765 A.2d 910, 916-17 (Del. 2000) (internal citations and quotation marks omitted).

Even if the plaintiff meets its burden, however, that "does not create *per se* liability on the part of the directors." *Id.* at 917 (internal quotation marks omitted). Rather, when a director invokes the business judgment rule to shield himself or herself "from personal liability arising out of completed actions involving operational issues,"

> [T]he plaintiff [retains] the ultimate burden of persuasion. In such cases, the business judgment rule shields directors from personal liability if, upon review, the court concludes the directors' decision can be attributed to any rational business purpose.

Unitrin, 651 A.2d at 1374. That is, "[t]he Court gives great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute our views for those of the board if the latter's decision can be attributed to any rational business purpose." *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 n.17 (Del. 1994) (internal quotation marks and citations omitted). Moreover, "duty of care violations are actionable only if the directors acted with gross negligence." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005).

Finally, it is worth noting that only directors and officers are obligated by the "triad" of fiduciary duties—the fiduciary duties of good faith, care, and loyalty. *See* RSA 293-A:8.30(a) (directors); RSA 293-A:8.42(a) (officers). By contrast, the duties of an entity's employees, including an Executive Director, are those of an agent. An agent's duties are limited to two categories of duties: duties of service and obedience, and duties of loyalty. *See* Restatement (2d) of Agency §§ 376-386, 387-398. Duties of service and obedience include:

- Duties set forth in an employment contract. *Id.* § 377.
- Duties to act "with standard care and with the skill which is standard in the locality for the kind of work," and "to exercise any special skill" that the agent has. *Id.* § 379.
- The duty not to conduct himself or herself with impropriety. *Id.* at 380.
- The duty to act only as authorized. *Id.* § 383.
- The "duty to obey all reasonable directions." *Id.* § 385.

In addition, the LGC Bylaws specifically delineate the distinct duties and powers of the directors, on the one hand, and the Executive Director, on the other. *See* Bylaws §§ 8.1-8.2 (directors); 8.3-8.4 (executive director).

It is unsurprising that there are substantial distinctions in the duties conferred by statute, common law, and the LGC Bylaws on directors, and those conferred on employees. Directors have policy-making authority over an organization. *See Revlon, Inc.*, 506 A.2d at 179 ("The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors.”). Employees, including the Executive Director, are responsible for carrying out those policies, and because they are required to obey directions and act only as authorized, may not deviate beyond the bounds of Board-set policies on their own authority. *See, e.g.*, Restatement (2d) of Agency §§ 377, 383, 385; LGC Bylaws §§ 8.3-8.4. Consequently, because they do not have responsibility for policy-making, employees, including the Executive Director, should not be required to answer for the organization’s policy decisions.

B. Analysis

The BSR has alleged that Respondents breached their fiduciary duties when they undertook certain actions. As Executive Director, neither Ms. Carroll nor Mr. Andrews owe a fiduciary duty of care to LGC, Inc., the risk pools, or the members.[2] Rather, their duties and responsibilities are governed by the LGC Bylaws and their employment contracts. Alternatively, and with regard to the remaining Respondents, this tribunal must determine, with respect to each transaction at issue:

1) Has the BSR effectively provided evidence that Respondents breached the duty of good faith or the duty of due care?[3]
2) If so, can the BSR demonstrate that the decision cannot “be attributed to any rational business purpose” and that the directors acted with “gross negligence”?

Walt Disney Co., 907 A.2d at 750; *Paramount*, 637 A.2d at 45 n.17; *Cede & Co.*, 634 A.2d at 361. If the BSR cannot meet its burden, than this tribunal may not invalidate the decision or substitute its views for those of the board.

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[2] There is no allegation that either Ms. Carroll or Mr. Andrews violated the duty of loyalty.

[3] There is no allegation that any director violated the duty of loyalty, that is, that he or she did not reasonably believe him or herself to be acting in the best interests of the organization when he or she made decisions.

1. *The Decision to Merge HealthTrust, Inc. and NHMA Property-Liability Trust, Inc., with each other and with NHMA, Inc.*

At the hearing, Respondents will present evidence that the governing boards of HealthTrust, Inc. and NHMA Property-Liability Trust, Inc. each engaged in an extensive process over a two year period to determine whether it was in the interest of HealthTrust, Inc., and in the interest of NHMA Property-Liability Trust, Inc., to join together in a common enterprise with each other and with NHMA, Inc.. An array of independent experts and counsel aided and advised the independent Boards during this process. As will be established at the Hearing through the introduction of Board minutes and expert presentations made to the Boards, there was a robust and dynamic debate among Board members in the exercise of their fiduciary duties. This extensive process culminated in independent determinations on April 7, 2003, by each of the governing boards that "each separately and jointly deem it advisable and generally to the welfare and advantage of each Company and all of their respective members and the employees of members, that the Companies be consolidated into an organization represented by a single board."[4]

The business judgment rule attaches to Respondents' actions in deciding to merge HealthTrust, Inc., NHMA Property-Liability Trust, Inc., and NHMA, Inc. Accordingly, the burden will first be on the BSR to "effectively provide evidence" that one or more Respondents violated the duty of good faith or the duty of due care. If it can meet its burden, it must then

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[4] As the Bylaws of LGC, Inc. have indicated since that time,

> In 2003, the Executive Committee or Boards of Trustees, as the case may be, of the New Hampshire Municipal Association, Inc. ("NHMA, Inc."), the New Hampshire Municipal Association Property-Liability Trust, Inc. ("PLT, Inc."), and HealthTrust, Inc. ("HealthTrust, Inc."), each separately and jointly deemed it advisable and generally to the welfare and advantage of each of them and their respective members and the employees of their members, that they be consolidated into a reorganized structure governed by a single Board of Directors. Accordingly, they each adopted a joint resolution to effectuate the reorganization.

LGC Bylaws, Recital "A."

demonstrate that the decision cannot "be attributed to any rational business purpose" and that the directors acted with "gross negligence." *Walt Disney Co.*, 907 A.2d at 750; *Paramount*, 637 A.2d at 45 n.17; *Cede & Co.*, 634 A.2d at 361. If the BSR cannot meet this burden, the tribunal may not invalidate the decision, reexamine its reasonableness, or substitute its views for those of the board. *See Paramount*, 637 A.2d at 45 n.17.

Respondents will present evidence that in reaching this determination, the independent boards of HealthTrust, Inc. and NHMA Property-Liability Trust, Inc. acted in good faith and in the interest of the organizations and their members. They will present evidence that they acted with due care as a reasonably prudent person would act, and did so after having obtained the opinions of and in reliance upon the opinions of numerous experts, including risk pool specialists, actuaries, accountants, LGC staff, and legal counsel. Finally, they will present evidence that there was ample rational business purpose for undertaking the decision to merge. Accordingly, this tribunal must conclude that Respondents breached no fiduciary duty in deciding to merge the entities.

2. *The Original Seed Money for the Workers' Compensation Pool and the Strategic Planning Transfer*

At the hearing, Respondents will present evidence that the independent governing boards of HealthTrust, Inc. and NHMA Property-Liability Trust, Inc. in 1999-2000 engaged in an extensive process to determine whether it was in their interest to use their own funds as seed money to create a new Workers' Compensation pool. Each board independently decided that it was in its respective entity's best interests to undertake this process.[5] Respondents will also present evidence that the board of LGC, Inc. also engaged in an extensive process to determine

[5] The capitalization of the funding of the workers compensation program was reported to the Secretary of State in financial filings.

whether it was in the interest of LGC, its members, *and its existing risk pools* to use a tiny percentage of total employer contributions to support the new Workers' Compensation pool and to engage in other strategic activities that benefited the pools as a whole. This extensive process culminated in the determination to use funds in this manner.

Before undertaking the decision to transfer funds to the Workers' Compensation pool, the LGC Board solicited extensive advice: from consultants as to the desirability of the transfer, from its actuary as to the economic benefits of the transfer, and from its attorney as to the legality of the transfer. It determined that the transfer was not only in the interest of LGC and its members as a whole, but that it was in the interest of the individual risk pools. In particular, the LGC Board determined that members of the HealthTrust pool, whether or not they chose to participate in the Workers' Compensation pool, would realize a financial benefit in the form of decreased claims and ultimately decreased premium costs. Those members who chose to participate in more than one line of coverage would realize the benefits of integrated benefit management, something members had requested and that the LGC Board had determined was desirable to implement.

Once the transfer was implemented, its continuation was repeatedly revisited and debated by the LGC Board in subsequent years until it was ultimately determined that the Workers Compensation pool subsidy should be ended. The Strategic Plan, which was always intended to be temporary, had accomplished its purpose in creating a viable Workers' Compensation pool for the benefit of members. The annual transfer was therefore eliminated. Ultimately, in response to Member concerns, the amount transferred was re-characterized as a loan and executed as a promissory note, with the intention that the Workers' Compensation pool will repay the amount of the strategic planning transfer that it received back to the HealthTrust pool over time.

The business judgment rule attaches to Respondents' actions in deciding to undertake the initial seeding of a Workers' Compensation pool and the Strategic Planning Transfer. Accordingly, the burden will first be on the BSR to come forward with evidence that one or more Respondents violated the duty of good faith or the duty of due care. If it can meet its burden, it must then demonstrate that the decision cannot "be attributed to any rational business purpose" and that the directors acted with "gross negligence." *Walt Disney Co.*, 907 A.2d at 750; *Paramount*, 637 A.2d at 45 n.17; *Cede & Co.*, 634 A.2d at 361. If the BSR cannot meet this burden, the tribunal may not invalidate the decision, reexamine its reasonableness, or substitute its views for those of the board. *See Paramount*, 637 A.2d at 45 n.17.

Respondents will present evidence that in deciding to fund a Workers' Compensation pool, the Boards of HealthTrust, Inc. and NHMA Property-Liability Trust, Inc., and later of LGC, Inc. acted in good faith and in the interest of the organizations and their members. They will present evidence that they acted with due care as a reasonably prudent person would act, and did so after having obtained the opinions of and in reliance upon the opinions of numerous experts, including risk pool specialists, actuaries, and legal counsel. Finally, they will present evidence that there was ample rational business purpose for undertaking the seeding of the Workers' Compensation pool and the Strategic Planning Transfer, and that the pool was intended to benefit the existing members of the other pools. Accordingly, this tribunal must conclude that Respondents breached no fiduciary duty in deciding to undertake the transfer.

3. *Setting of Reserve Level*

At the hearing, Respondents will present evidence that the LGC Board engaged in an extensive process to determine the most appropriate methodology of calculating its reserves and the level of reserves to maintain. In doing so, the LGC Board solicited advice from its actuary, surveyed the practices of other risk pools and non-profit health insurers, consulted with legal counsel, and engaged in a robust debate about the merits of various reserve levels. Moreover, the solicitation of advice from the actuary, consultation with legal counsel, and robust debate over the appropriate reserve level *continued* on an ongoing basis even after the board initially determined in 2002 to adopt the risk-based capital methodology for HealthTrust at a level of RBC 4.2.[6] Respondents will present extensive evidence of countless debates and discussions, with active participation by experts and awareness by board members of the potential consequences of their actions on pool solvency, on the finances of member towns, and on LGC's ability to continue to offer attractive products that meet the needs of member towns.

Respondents will present evidence that each and every one of these decisions affecting the reserve level involved extensive board discussion and ongoing consultation with experts. The LGC Board routinely revisited the question of reserve level to determine whether the level should be raised or lowered to maintain an adequate amount of reserves. The LGC Board took these decisions extremely seriously, wrestling robustly with the challenges of decision-making under uncertainty.

The business judgment rule attaches to Respondents' actions regarding the setting of reserve levels. Accordingly, the burden will first be on the BSR to come forward with evidence that one or more Respondents violated the duty of good faith or the duty of due care. If it can meet its burden, it must then demonstrate that the decision cannot "be attributed to any rational business purpose" and that the directors acted with "gross negligence." *Walt Disney Co.*, 907 A.2d at 750; *Paramount*, 637 A.2d at 45 n.17; *Cede & Co.*, 634 A.2d at 361. If the BSR cannot

[6] From 2006-2009, the LGC Board added an additional 0.5 of RBC to meet LGC's need for administrative reserves.

meet this burden, the tribunal may not invalidate the decision, reexamine its reasonableness, or substitute its views for those of the board. *See Paramount*, 637 A.2d at 45 n.17.

Respondents will present evidence that in deciding to set reserves at a particular RBC level, the LGC Board acted in good faith and in the interest of the organization and its members. They will present evidence that the Board acted with due care as a reasonably prudent person would act, and did so after having obtained the opinions of and in reliance upon the opinions of numerous experts, including risk pool specialists, actuaries, accountants, LGC staff, and legal counsel. Finally, Respondents will present evidence that there was ample rational business purpose for setting reserves at the particular chosen level. Accordingly, this tribunal must conclude that Respondents breached no fiduciary duty in setting reserve levels.

4. *Return of Surplus Through Rate Stabilization*

At the hearing, Respondents will present evidence that the LGC Board engaged in extensive debate and discussion to determine the most appropriate way to return surplus to member towns. The Board was aware that prior experiences with returning surplus as "dividends" to towns had wreaked havoc with town budgets, and that rate stabilization across budget years was, for the member towns, a much more important goal to achieve. Accordingly, after consultation with its legal counsel about how to satisfy the requirement of RSA Ch. 5-B that surplus be returned, and discussions with its actuary about the appropriate amount to return, the LGC Board determined that it would return surpluses through a process of rate stabilization. As health care costs continued to climb in the late 2000s, the LGC Board engaged in frequent discussions with its actuary about the appropriate amount to return. In several years, it even overrode its actuary's recommendation on the appropriate level of "risk charge" needed to maintain its reserves, instead determining that it would keep rates lower than the actuary had suggested. That is, it held down the amount of the rise in rates, even at the risk of excessive depletion of the reserves.

Respondents will present evidence that each and every one of these decisions affecting return of surplus involved extensive board discussion and ongoing consultation with experts. The LGC Board took these decisions extremely seriously, wrestling robustly with the challenges of decision-making under uncertainty.

The business judgment rule attaches to Respondents' actions regarding the return of surplus. Accordingly, the burden will first be on the BSR to come forward with evidence that one or more Respondents violated the duty of good faith or the duty of due care. If it can meet its burden, it must then demonstrate that the decision cannot "be attributed to any rational business purpose" and that the directors acted with "gross negligence." *Walt Disney Co.*, 907 A.2d at 750; *Paramount*, 637 A.2d at 45 n.17; *Cede & Co.*, 634 A.2d at 361. If the BSR cannot meet this burden, the tribunal may not invalidate the decision, reexamine its reasonableness, or substitute its views for those of the board. *See Paramount*, 637 A.2d at 45 n.17.

Respondents will present evidence that in deciding to gradually return surplus through rate stabilization, the LGC Board acted in good faith and in the interest of the organization and its members. They will present evidence that the Board acted with due care as a reasonably prudent person would act, and did so after having obtained the opinions of and in reliance upon the opinions of numerous experts, including actuaries and legal counsel. Finally, Respondents will present evidence that there was ample rational business purpose for returning surplus gradually over time through rate stabilization rather than via dividend checks or some other method. Accordingly, this tribunal must conclude that Respondents breached no fiduciary duty in returning surplus through rate stabilization.

CONCLUSION

For the foregoing reasons, and based upon the evidence to be presented at the hearing, this tribunal should conclude that Respondents did not breach their fiduciary duties.

Dated: April 27, 2012

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have, this 27th day of April 2012, forwarded copies of this pleading *via* E-mail to counsel of record.

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