STATE OF NEW HAMPSHIRE
DEPARTMENT OF STATE
BUREAU OF SECURITIES REGULATION

IN THE MATTER OF:	)	
Local Government Center, Inc.; et al.	)	Case Number: C-2011000036
	)	

LGC'S MOTION TO DISMISS COUNTS III, IV, AND V OF THE AMENDED PETITION ON THE GROUND THAT LGC'S RISK POOL CONTRACTS ARE NOT SECURITIES OR ARE EXEMPT UNDER NEW HAMPSHIRE LAW

Respondents Local Government Center and affiliated entities ("LGC") submit this motion to dismiss Counts III, IV, and V of the Amended Petition on the ground that LGC's risk pool contracts are not securities within the meaning of either of the tests the Bureau of Securities Regulation ("BSR") cites in its Amended Petition. In the alternative, if they are securities, the risk pool contracts are exempt from the requirements of RSA 421-B under New Hampshire's securities laws.

I. Introduction

1. Count III of BSR's Amended Petition alleges that LGC's risk pool contracts are securities and that LGC[1] and its entities should therefore have registered the risk pool contracts as securities under RSA 421-B:11. Amended Petition ¶112.

2. Count III also alleges violations of RSA 421-B:6 on the theory that if the risk pool contracts are securities, then LGC should have registered as a "broker-dealer," and LGC HealthTrust, LLC, LGC Property Liability Trust, LLC, and LGC Workers' Comp Trust, LLC should have registered as "issuer-dealers." Amended Petition ¶113-15.

3. Count IV alleges that the Individual Respondents named in the Amended Petition either "knowingly or negligently aided LGC in selling unregistered securities in violation of RSA 421-B:11." Amended Petition ¶120.

[1] The Amended Petition uses "LGC" to refer to a collection of "individuals and certain entities," presumably encompassing all of the respondents and those entities listed in ¶¶3-21 of the Amended Petition.

4. Count V alleges that because the risk pool contracts are securities that were not registered as securities, and because LGC did not register as a broker-dealer or issuer-dealer, LGC violated RSA 421-B:3 by not disclosing these failures to register to members and potential members. Amended Petition ¶125. Count V further alleges that certain of LGC's uses of member funds are prohibited under RSA 5-B, and that the failure to disclose those alleged violations of RSA 5-B was itself a violation of the disclosure requirements of RSA 421-B:3.[2]

II. The Risk Pool Contracts are Not Securities

5. LGC's risk pool contracts are not securities under either of the tests BSR cites.

A. The Risk Pool Contracts are Not Securities Under the *Howey* Test

6. The *Howey* test is a four-part test used to determine whether an "investment contract" is a security. *See SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). It is the only test that BSR has ever applied to determine whether a contract is a security. *See When are "Notes" Securities Under the New Hampshire Uniform Securities Act*, State of New Hampshire Department of State Bureau of Securities Regulation Statement of Policy, November 16, 2010, at *8, *available at* http://www.sos.nh.gov/securities/PDF/Interpretive_Orders/IntOrd_2010-11-19.pdf (stating the Bureau's position that the *Howey* test "is the proper definition for *all securities*" (emphasis in original)); *see also In re Gary Arthur Gahan*, COMO5-028, at *3 (N.H. Cur. Sec. Reg., Dec. 30, 2008); *In re Viatical Investments, Status As Securities*, INTO4-003, at *1 (N.H. Bur. Sec. Reg., Oct. 25, 2004).

7. The *Howey* test has four elements: (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) solely from the efforts of the promoter or third party. *Howey*, 328 U.S. at 301. The test thus asks whether the investment contract "involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* The risk pool contracts at issue in this case fail to meet three of the four *Howey* requirements.

[2] The focus of this motion is on Count III. Counts IV and V are premised on Count III, so if Count III fails, Counts IV and V would necessarily meet the same fate.

1. The Risk Pool Members Did Not Have an Expectation of Profits

8. The risk pool contracts are not securities because the schools, counties, towns, cities, and other local governments that are members of LGC, when they entered into the risk pool contracts, did not have an expectation of profits (the third *Howey* requirement). The local governments which contract with LGC are not motivated by profit, but rather by a desire to purchase risk coverage in order to manage their risks. The risk pool contracts are not magically transformed into securities simply because it is possible that the participants might receive a return of some portion of their contribution. For there to be an expectation of profit, there must be an expectation of appreciation in the value of an investment; the potential for the return of some portion of the contributed funds is not enough. *See Howey*, 328 U.S. at 299 (security exists where "a person invests his money in a common enterprise and is led to expect *profits* . . . .")(emphasis added).

9. Although surplus was returned to the risk pool members, either as a payment or as a structured rate reduction, the mere expectation that a portion of the money paid for risk coverage might be returned does not amount to an expectation of *profit*, but rather an expectation of a potential *rate reduction*.

10. In *Teamsters v. Daniel*, 439 U.S. 551 (1979), the Supreme Court rejected the argument that there was an expectation of profit on the part of an employer that participated in an pension fund, despite the fact that the fund invested (and hoped to earn a return on) its assets, because "a far larger portion of [the pension fund's] income comes from employer contributions, a source in no way dependent on the efforts of the Fund's managers." *Id.* at 562. Although contributions to the pension fund were invested by fund managers, which could cause the level of benefits to exceed employer contributions, the court found no expectation of profit on the part of employers who contributed to it. "Not only does the greater share of a pension plan's income ordinarily come from new contributions, but unlike most entrepreneurs who manage other people's money, a plan usually can count on increased employer contributions, over which the plan itself has no control, to cover shortfalls in earnings." *Id.*

11. The same logic applies here. Although LGC does invest the money it receives from risk pool members, that investment is not the primary source of LGC's revenue. And the

members, when entering into risk pool contracts, do not expect to *profit* from their purchase of risk coverage; they simply expect to receive risk coverage at a reasonable price.

12. For a purchase contract to be a security, the purchaser must be motivated by the possibility of return on an investment, not by a desire to use an item being purchased. As the Court explained in *United Housing v. Forman*:

> By profits, the Court has meant either capital appreciation resulting from the development of the initial investment . . . or participation in earnings resulting from the use of investors' funds . . . . In such cases the investor is "attracted solely by the prospects of return" on his investment. By contrast, when a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply.

421 U.S. 837, 852-53 (1975). *Forman* held that shares of stock which entitled the purchasers to lease an apartment in a housing development were not securities, because "the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit." *Id*. at 851. If rent paid by tenants in *Forman* had exceeded expenses, the difference would have been returned to the tenants as a rebate, but the court found that "the possibility of some rental reduction is not an 'expectation of profit' in the sense found necessary in *Howey*." 421 U.S. at 857.

13. Much like the situation in *Forman*, while risk pool members might experience a reduction in their rates from the return of surplus, that possibility is not what motivated them to enter into the risk pool contracts. Instead, the motivation was a desire *to purchase risk coverage*—that is, a "desire to use or consume the item purchased." 421 U.S. at 853.

14. Further support for the conclusion that the risk pool contracts are not securities is found in the fact that political subdivisions in New Hampshire only have the authority to take actions that are specifically authorized by the legislature. "[T]owns are but subdivisions of the State and have only the powers the State grants to them." *Piper v. Meredith*, 110 N.H. 291, 295 (1970) (internal quotation marks omitted). RSA 5-B:3, which authorizes political subdivisions to enter agreements to participate in pooled risk management programs, specifically limits the purposes of such agreements: "[a]greements made pursuant to this paragraph may provide for pooling of self-insurance reserves, risks, claims and losses, and of administrative services and

expenses associated with them among political subdivisions." RSA 5-B:3 I. The statute does *not* authorize entry into risk management pools in pursuit of profit, and political subdivisions are therefore legally prohibited from doing so. As such, they could not possess the "reasonable expectation of profits" required to meet the *Howey* test. *Forman*, 421 US at 852.

2. A Speculative or Insubstantial Possibility of Profits is Insufficient to Create a Security

15. Even if the local governments are deemed to have had some remote inkling of a potential profit in connection with the risk pool contracts, such a possibility would have been too speculative and insubstantial to render the risk pool contracts securities. It is well established that a theoretical, abstract, or speculative possibility of profits is not sufficient for a court to find an "expectation of profits" within the meaning of the *Howey* test." In *Teamsters v. Daniel*, the Court ruled that to the extent that the investment earnings of a pension plan could be described as "profit," that potential was far too theoretical to create an "expectation of profits." 439 U.S. at 552. The Court concluded that "the possibility of participating in a plan's asset earnings 'is far too speculative and insubstantial to bring the entire transaction within the Securities Acts.'" *Id.* (citing *Forman*, 421 U.S. at 856).

16. Likewise here, even if the risk pool members had somehow expected to realize something that could be fairly characterized as a "profit" on their purchase of risk coverage, such an outcome would have been just as speculative, and its likelihood just as insubstantial, as was the possibility of profit in connection with the pension plan earnings in *Teamsters v. Daniel*. Whether surplus is returned by LGC, and how much is returned, depends on a number of factors, such as the ability of LGC to accurately anticipate claims and expenses for the year. Like the possibility that the pension plan participants in *Daniel* might share in the plan's asset earnings, any speculative and insubstantial possibility of risk pool members realizing a profit in connection with their dealings with LGC would be insufficient to create a security.

3. The Risk Pool Members Have Not Made an "Investment of Money" with LGC

17. In addition to failing to meet the "expectation of profit" element of the *Howey* test, entry into risk pool contracts also fails to meet the requirement under *Howey* that there be an "investment of money." *Howey*, 328 U.S. at 301.

18. As explained *supra*, local governments paid money to LGC in exchange for a valuable benefit: risk coverage. The purchase of a good or service on contractual terms that leave the exact price to be paid undetermined is not an "investment" in the common sense of the word.

19. BSR's contention that participants have made an "investment" in risk pool contracts—and that they have an expectation of "profit" from that "investment"—simply does not make sense.[3]

4. The Outcome of the Risk Pool Members' Purported "Investment" Does Not Depend Solely on the Efforts of LGC

20. Even if the other elements of the *Howey* test were met, the risk pool contracts still would not meet the requirements for a security under *Howey*, because any fruits of the purported "investment" made by the risk pool members would not be derived "solely from the efforts of the promoter or third party." 328 U.S. at 301. Although the financial performance of LGC's risk pools depend in part on the performance of its investments, the primary determinant of the financial performance of a risk pool is claims experience, that is, how the risks being pooled develop in a given year and how much money is paid out in claims. *See* R.S.A. 5-B:3, I (purpose of the statute is to provide for "pooling of self-insurance reserves, risks, claims and losses . . . ."). By definition, a risk management pool manages *risks*, which means the actual amount paid out in claims will vary from year to year. Actual claims experience, of course, is *not* something that is determined by "the efforts of [LGC]"; it is instead determined by the number and amount of claims made against each risk pool member. The members' own claims experience determines the financial performance of the program. This is yet another requirement of the *Howey* test that is not met.

[3] In ¶ 107 of the Amended Petition BSR asserts that "membership interests in NHMA, LLC" are "'investment contracts' . . . ." BSR offers no explanation or facts to support this assertion.

B. The Risk Pool Contracts are Not Securities Under the Risk Capital Test

21. New Hampshire state cases have always applied the *Howey* test. *See State v. Heneault*, 121 N.H. 497, 499-500 (1981); *see also When are "Notes" Securities Under the New Hampshire Uniform Securities Act*, State of New Hampshire Department of State Bureau of Securities Regulation Statement of Policy, November 16, 2010, at *8, *available at* http://www.sos.nh.gov/securities/PDF/Interpretive_Orders/IntOrd_2010-11-19.pdf (Stating the Bureau's position that the *Howey* test "is the proper definition for *all securities*." (emphasis in original)); *In re Gary Arthur Gahan*, COMO5-028, at *3 (N.H. Cur. Sec. Reg., Dec. 30, 2008); *In re Viatical Investments, Status As Securities*, INTO4-003, at *1 (N.H. Bur. Sec. Reg., Oct. 25, 2004).

22. BSR has never sought to apply the Risk Capital test before this, and should not be permitted to hold LGC to this newly-decreed standard.

23. The "Risk Capital" test has four elements: (1) an investment furnishing initial value to the offeror; (2) a portion of this initial value is subjected to the risks of the enterprise; (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise. *State v. Hawaii Market Center, Inc.*, 52 Haw. 642, 649 (1971); *see also Meyer v. Dans un Jardin*, 816 A.2d 533, 536 (10th Cir. 1987) (under the Risk Capital test, a "security is present whenever the investors' funds provide the initial or 'venture' capital needed to develop a new enterprise over which the investors exercise little or no managerial control.").

24. The New York Court of Appeals has distinguished the purchase of a security from a standard economic transaction:

> Risk capital is furnished *not in exchange for immediate benefit* but to establish a prospective enterprise; some or all of a subscriber's initial value is at risk if the enterprise fails; and the subscriber's payment is made in the expectation that he will enjoy the benefits of the enterprise if and when it is successfully completed.

All Seasons Resorts v. Abrams, 68 N.Y.2d 81, 93, 497 N.E.2d 33 (1986) (emphasis added). As formulated by BSR, under the risk capital test, an investment is a security when the investor funds a business venture with an expectation of receiving "a valuable benefit of some kind, over and above the initial value." Amended Petition ¶110. LGC's risk pool contracts do not fit this description. As explained *supra*, payments made by risk pool participants *are* for an immediate benefit—risk coverage—and are *not* made with any expectation of receiving any benefit from LGC's business "over and above the initial value" contributed.

25. In *State v. Hawaii Market Center*, 52 Haw. 642, 650 (1971), premiums were paid by investors "in consideration for the right to receive future income from the corporation." The court found the requirements for the existence of a security were met because "[i]nextricably bound to the success of this enterprise is the ability of the founder-members to recoup their initial investment and earn income." *Id*. Here, local governments made payments to LGC in exchange for risk coverage, and could not have expected that, in additional to receiving that coverage, they would "recoup their initial investment and earn income" on top of it. *Id*.

26. The success of LGC as an enterprise is not judged based on whether it returns investment income to risk pool members, but on whether it provides adequate risk coverage. Without the expectation that the initial investment is given in return for the right to receive future income from the corporation, there is no security under the "Risk Capital" test.

III. The Risk Pool Contracts are Exempt under New Hampshire Securities Laws

27. BSR alleges in the Amended Petition that LGC has violated RSA 421-B:6 and 421-B:11 by failing to register the risk pool contracts as securities and by failing to register as issuer-dealers or as broker-dealers. These allegations are without merit because, as just explained, the risk pool contracts are not securities. Moreover, even if the risk pool contracts were somehow deemed to be securities, LGC and the risk pool contracts would be exempt from the registration requirements BSR cites under RSA 421-B:17.

28. RSA 421-B:17, I(a) exempts securities "issued or guaranteed" by "subdivision[s] of a state" or "other instrumentalit[ies]" of a state. The New Hampshire Supreme Court has found that LGC and its sub-entities are governmental entities; therefore they are instrumentalities of the state and subject to the exemption at RSA 421-B:17.

29. In 2004, in a dispute with the Professional FireFighters of New Hampshire, the Supreme Court of New Hampshire determined that LGC HealthTrust was subject to RSA Chapter 91-A (access to public records and meetings). *PFFNH v. HealthTrust, Inc.*, 151 N.H. 501, 504-05 (2004). The court considered whether RSA 91-A, which applies to "any board, commission, agency or authority, of any county, town, municipal corporation . . . or other political subdivision, or any committee, subcommittee or subordinate body thereof, or advisory committee thereto," applied to LGC HealthTrust. *Id*. at 504. The court determined that RSA 91-A applied, for the following reasons:

- First, HealthTrust is an organization comprised exclusively of political subdivisions, which, notably, are subject to the Right-to-Know Law;
- Second, HealthTrust is governed entirely by public officials and employees;
- Third, HealthTrust provides health insurance benefits for public employees through a pooled risk management program, which the legislature has recognized "is an essential governmental function";
- Fourth, HealthTrust operates for the sole benefit of its constituent governmental entities and for the sole purpose of managing and providing health insurance benefits for public employees;
- Finally, HealthTrust manages money collected from governmental entities and enjoys the tax-exempt status of public entities.

PFFNH v. HealthTrust, 151 N.H. at 504.

30. Six years later, in *PFFNH v. LGC, Inc.*, 159 N.H. 699 (2010), the New Hampshire Supreme Court considered a similar question with regard to LGC, Inc., the New Hampshire Municipal Association, LLC ("NHMA") and Local Government Center Real Estate, Inc. ("LGC Real Estate"). In that case, LGC conceded that LGC, Inc. was a "governmental entity." *Id*. at 705. Based on LGC, Inc.'s status, and the structural relationship between the three entities, the court concluded that NHMA and LGC Real Estate "are conducting the public's business," and were therefore subject to RSA 91-A.

31. RSA 91-A is intended to provide public access to "governmental proceedings," *PFFNH v. HealthTrust*, 151 N.H. at 504. In the 2010 case the court declared that the question was whether "the entity is conducting the public's business." *PFFNH v. LGC, Inc.*, 159 N.H. at 705. The court concluded that it was, based on the "structure and function" of NHMA and LGC

Real Estate and "their relationship with LGC, which has a conceded status as a governmental entity." *Id*. at 706. Because RSA 91-A provides access to governmental proceedings, and LGC and its sub-entities have been found by the New Hampshire Supreme Court to have been "conducting the public's business," they are instrumentalities of the state within the meaning of RSA 421-B:17, and are exempt from the registration requirements of RSA 421-B.

IV. Conclusion

32. Because the risk pool members did not have an expectation of profits, and did not make an investment of money with LGC, and because the financial performance of the risk pools does not depend solely on the efforts of LGC, the risk pool contracts are not securities. Moreover, LGC would be exempt from the securities laws even if they were. Counts III, IV & V should therefore be dismissed.

WHEREFORE, LGC respectfully requests that the Hearing Officer:

A. Dismiss Count III, IV & V of the Amended Petition against LGC; and

B. Grant any other such relief as may be necessary and proper.

Respectfully submitted,

LOCAL GOVERNMENT CENTER, INC.;
LOCAL GOVERNMENT CENTER REAL ESTATE, INC.;
LOCAL GOVERNMENT CENTER HEALTHTRUST, LLC;
LOCAL GOVERNMENT HEALTHTRUST, LLC;
LOCAL GOVERNMENT CENTER PROPERTY-LIABILITY TRUST, LLC;
HEALTHTRUST, INC.;
NEW HAMPSHIRE MUNICIPAL ASSOCIATION PROPERTY-LIABILITY TRUST, INC.;
LGC-HT, LLC; AND
LOCAL GOVERNMENT CENTER WORKERS' COMPENSATION TRUST, LLC,

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Dated: March 12, 2012

By: */s/ William C. Saturley*

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CERTIFICATE OF SERVICE

I hereby certify that I have this 12th day of March delivered copies of this pleading to all counsel.

/s/William C. Saturley