STATE OF NEW HAMPSHIRE
DEPARTMENT OF STATE

IN THE MATTER OF:	)	
	)	Case No: C2011000036
Local Government Center, Inc., et al.	)	

BUREAU OF SECURITIES REGULATION'S TRIAL MEMORANDUM

NOW COMES Petitioner, the New Hampshire Bureau of Securities Regulation (the "Bureau" or the "Petitioner"), through counsel Bernstein, Shur, Sawyer & Nelson, P.A., and submits this trial memorandum setting forth the legal arguments and factual support for its claims against the Respondents.

Introduction

The Bureau's Amended Petition set forth six Counts against the Respondents alleging multiple violations of R.S.A. ch. 5-B and R.S.A. ch. 421-B.[1] In particular, the Bureau alleges that the Respondents' actions in overcharging premiums to towns, cities, school districts and counties in order to build a war chest to combat Primex, a perceived competitor, and using the war chest, in part, to subsidize a financially failing workers' compensation pool without seeking the consent of the members of the health and property-liability risk pools whose money they were diverting, constituted multiple violations of the enabling statute, R.S.A. ch. 5-B. In fact, the LGC Board itself called such overcapitalization and inter-pool subsidization "unethical" and "unscrupulous" not long before implementing the very same measures.

The Respondents took advantage of a newly adopted parent-subsidiary structure that allowed the single LGC Board to authorize improper transfers that were not in the best interests of the members of the health and property-liability pools, and to hide the subsidy payments as distributions to LGC Parents for a "strategic plan." The Respondents' systematic

[1] Count Six was voluntarily dismissed by the Bureau prior to the hearing.

overcapitalization resulted in the collection and retention of hundreds of millions of dollars from towns, cities, school districts and counties during a decade when that money could have been used to retain employees and services, replace or update deteriorating equipment like police cars and failing furnaces, and to reduce property taxes for the citizens. Only a tiny portion of these excess net assets were ever returned to LGC's members as required by the statute. *See* R.S.A. 5-B:5, I(c). Instead, the Respondents replaced their computer system, propped up a failing workers' compensation pool, and spent millions of dollars on lobbying efforts and litigation to preserve LGC's improper activities.

In addition, the Respondents never registered the participation agreements in the LGC risk pools as a security, or sought a no-action letter and/or exemption from the Bureau, and have continuously violated the Uniform Securities Act's requirements of registration and licensure.

Even giving the Respondents the benefit of doubt that they acted in good faith when engaging in the identified violations of RSA 5-B, the Respondents refused to adjust their practices in response to the Bureau's investigative findings. By contrast, when the Bureau approached other 5-B risk pools in New Hampshire about similar violations to R.S.A. 5-B, the other risk pools cooperated with the Bureau's investigation and ultimately entered into agreements to conform their practices to statutory requirements. Exhs. BSR 64, 65.

After protracted discovery disputes and a flurry of comprehensive dispositive motions filed by the Respondents extended proceedings into April, a ten-day evidentiary hearing was conducted from April 30, 2012 through May 11, 2012. As set forth more fully below, the evidence and testimony presented at the hearing confirm the Respondents' violations of R.S.A. 5-B by (1) operating through an improper parent-subsidiary corporate structure where each pooled risk management program does <u>not</u> have an independent board of directors or bylaws; and (2) amassing and retaining excess surplus that is used for improper purposes such as subsidizing the financially failing Workers' Compensation Pool; and (3) failing to return surplus funds to the Members. In addition, the evidence and testimony confirmed the Respondents' violations of R.S.A. 421-B by (1) failing to register LGC Participation Agreements as securities; (2) selling said securities without being licensed as broker-dealers, issuer-dealers, or agents; and (3) committing securities violations through material omissions of the status of the Participation Agreements as securities.

For these reasons, the Bureau requests that the Presiding Officer find the enumerated violations of R.S.A. 5-B and R.S.A. 421-A by Respondents, and impose appropriate remedies and including rescission, restitution and disgorgement of surplus funds.

Statutory Authority

R.S.A. 5-B provides for liability for any violation of the provisions of the statute and empowers the Secretary of State, through the Presiding Officer, to enter "an order of rescission, restitution, or disgorgement directed to a person who has violated this chapter." R.S.A. 5-B:4-a, VII(b). No intent or knowledge is required to find a violation of the statute or to impose penalties, with the exception of administrative fines, which may only be imposed for "knowing" or "negligent" violations. R.S.A. 5-B:4-a, VII. The Presiding Officer may find any violations of the statute that occurred or continued on or after June 14, 2010, and impose appropriate penalties to remedy said violations. Id. Accordingly, the Presiding Officer's task is to interpret the statute and determine whether the Respondents' conduct constitutes a violation of any provision of R.S.A. 5-B. The Presiding Officer may also find that the risk pool management programs fail to comply with the standards described in RSA 5-B:5 and deem the exemptions under RSA 5-B:6 forfeited. The Respondents' knowledge, intent, and good and/or bad faith are relevant only to the question of whether administrative fines should be imposed.

Similarly, with regard to the Securities claims, R.S.A. 421-B requires that securities be registered with the Secretary of State and that persons issuing, offering or selling securities be licensed as broker/dealers, issuer-dealers, or agents. R.S.A. 421-B:6 & 11. Failure to register and acting without a license are *per se* violations of the statute regardless of intent. Thus, the Respondents' knowledge, intent, and good and/or bad faith are immaterial to the Presiding Officer's review of liability on Count III. Intent, knowledge and good/bad faith are relevant only to Counts IV and V and to a determination of the appropriate remedies for the three Securities claims. Like R.S.A. 5-B, the securities statute provides for the imposition of administrative fines not to exceed $2,500.00 per violation, for negligent or knowing violations of the securities laws, R.S.A. 421-B:26, III, or for direct or indirect control of a person who negligently or knowingly violated the statute. R.S.A. 421-B:26, III-a.

Accordingly, to the extent that the sound business judgment of the Respondents is relevant at all, its relevance is limited to the remedies available for violations of the statutes at issue. Sound business judgment is not a defense to statutory violations. Moreover, in order to qualify for the protections of R.S.A. 5-B:6, including tax exempt status and exemption from regulation by the Insurance Department, Respondents must comply with the standards described in RSA 5-B:5.

Analysis of Claims

I. Count I – Improper Corporate Structure

Count I of the Amended Petition alleges that LGC has been operating pooled risk management programs with an impermissible corporate structure in violation of the requirements of R.S.A. 5-B:5, I (b) and (e). Namely, LGC is in violation of R.S.A. 5-B:5's requirement that each pooled risk management program be governed by an independent board of directors and independent written bylaws. The Bureau incorporates and restates here the legal arguments set forth in its Omnibus Objection to Respondents' Dispositive Motions.

It is undisputed that since 2003, and continuing through today, the HealthTrust and Property-Liability Trust Pools have been operated by single member LLC's.[2] HT at 1574. The LLCs are separate legal entities that file separate 5-B informational filings with the Secretary of State each year. HT 1633-34 (McCue), and Exh. LGC 306 and LGC 306. Moreover, Respondents' admit that the LLC's do not have boards of directors or bylaws, though both are legally available under the LLC statute. HT 1631-32. The participation agreements in evidence make clear that Members are subject to the Local Government Center, Inc.'s bylaws and not those of the individual risk pool management programs. Exh. BSR 61 at 9 (§3). The same agreement makes clear that the Local Government Center operates two risk pool management programs. *Id. at* 8 ("Certain municipalities and other public entities of the State of New Hampshire, acting through the Local Government Center and pursuant to NHRSA 5-B, have created two pooled risk management programs….").

Instead, the Respondents adopted a corporate structure whereby LGC Parent, a non-profit corporation, is the single member of each of the LLC risk pools, and the Board of LGC Parent (the "LGC Board") manages the risk pools, as well as LGC's separate real estate holding company, LGC Real Estate, Inc., and lobbying and service organization, NHMA, LLC. As such, the Respondents have relieved the LGC Board from direct fiduciary duties to the LLC risk pools, HT 130, 1630.[3] The parent-subsidiary structure, where the LGC Board is responsible for governing multiple subsidiary entities with separate and distinct membership and interests, is

[2] LGC HealthTrust, LLC and LGC Property-Liability Trust, LLC. Between 2003 and 2007, the Workers' Comp. Pool was operated by a separate single member LLC, LGC Workers' Compensation, LLC., which was merged with LGC Property-Liability Trust, LLC on May 31, 2007. Joint Exh. 2.

[3] Nonetheless, Respondents admit, as they must, that the LGC Board owes fiduciary duties to the political subdivisions participating as members of each of the risk pools (the "Members"). HT 1995 (Samuels).

fraught with inherent conflicts of interest that run counter to the intent and purpose of R.S.A. 5-B's requirement of independent boards and bylaws for each pooled risk management program. HT 1996-99[4] *See also* Omnibus Obj. at 10-13. LGC's parent-subsidiary structure confuses and diminishes the clear fiduciary duties owed by a board of directors that governs a single pooled risk management program, in violation of the meaning and intent of R.S.A. 5-B:5, I(b).

Moreover, by converting the non-profit corporate entities that originally controlled the risk pools into LLCs managed by another entity, Local Government Center, Inc. ("LGC Parent"), the Respondents have shifted control over the disposition of Member assets at dissolution to the Board's discretion. Pursuant to statute, assets of a non-profit corporation flow to the members, while under an LLC, disposition of the assets at dissolution is controlled by the bylaws which may be amended by the Board by a simple majority vote.[5] Exh. LGC 222 at §6.10. Where the LGC Board has multiple, conflicting interests, there is no guarantee that the Members will receive the same priority they would under the traditional single-board, single entity non-profit corporation structure contemplated by the statute. Again, LGC's "creative" parent-subsidiary structure undermines critical protections built into the statute, including independent board and bylaws for each risk pool entity.

Respondents' argument that R.S.A. 5-B:3, III permits a single pooled risk management program to provide multiple lines of coverage misses the mark, because LGC operates two separate and distinct pooled risk management programs, neither one of which has a direct board or set of bylaws. LGC does not offer all of its lines of coverage under a single legal entity.[6] HT 1629-30. For over 25 years, LGC's health and property-liability pools have been operated

[4] Attorney Samuels testified that "the standard of conduct of a board member is that in good faith they have to make a determination that any action is in the best interest of whichever parties they are governing."
[5] The current LGC bylaws provide for a return of assets to the Members at dissolution. Section 10.1.
[6] Attorney McCue's protestations notwithstanding, the participation agreement in evidence for the town of Belmont acknowledges the existence of two risk pool management programs. Exh. BSR 61 at 8.

separately and until 2003 each pool had its own separate and independent board and set of bylaws. HT 401, 404 (Andrews). Both HealthTrust and Property Liability Trust offer multiple lines of coverage as permitted by R.S.A. 5-B:3, III.[7] HT 1382-83. However, the evidence shows that they are separate pooled risk management programs that must each have a separate and independent board of directors and set of bylaws to be compliant with R.S.A. 5-B and continue to enjoy the tax and regulatory protections of the statute.

Moreover, reading the provisions of RSA 5-B:5 in concert with each other makes clear the Legislature's intent that the governing board for each risk pool management program be within the entity that comprises that program. RSA 5-B:5, I (a) requires each program to "[e]xist as a legal entity organized under the laws of New Hampshire." RSA 5-B:5, I (b) requires governance of this entity to be by a board of a certain composition. The two provisions must be read together, as they appear juxtaposed. Otherwise, the statute could be read to require a New Hampshire entity house the New Hampshire risk pool, but the elected officials who comprise the board could be drawn from another state. This is an extremely unlikely expression of the Legislature's intent to create risk pools run by local New Hampshire officials for the benefit of their communities. The same statutory analysis, reading the provisions collectively as a reasoned whole, also applies with respect to the bylaws requirement. The written bylaws that are required must be for the New Hampshire entity that is governed by the New Hampshire officials. *See* RSA 5-B;5, I(e).

Because LGC is currently operating in violation of R.S.A. 5-B:5, I(b) and (e), the Bureau respectfully requests that the Presiding Officer enter an order finding Respondents in violation of the statute and ordering LGC to come into compliance with the statute by creating independent

[7] Whether operation of the health and property-liability pools by a single legal entity with a direct board and bylaws (as done by Primex, HT 1630 and Exh. LGC 454) is permitted under R.S.A. 5-B is not before the Presiding Officer.

boards with written bylaws for the HealthTrust and Property-Liability Trust pools within 90 days or submit to Insurance Department regulation as non-5-B pools and forego exemption from state taxation.

II. Count II – Accumulating Excess Surplus and Failing to Return Surplus to Members

Count II of the Bureau's Amended Petition alleges that the Respondents charged Members inflated rates in order to accumulate excessive capital ("net assets") not required for administration of pooled risk management programs; that the Respondents used net assets for inappropriate activities such as to subsidize a failing workers compensation pool; and that the Respondents have adopted an impermissible rate stabilization method that fails to return all surplus Member funds to the Members as mandated by R.S.A. 5-B:5, I(c). The Bureau incorporates and restates here the legal arguments set forth in its Omnibus Objection to Respondents' Dispositive Motions.

A. Adequate Reserves

The Presiding Officer's analysis must begin with the language and intent of the statute. R.S.A. 5-B:5, I(c) requires that each pooled risk management program shall:

> Return all earnings and surplus in excess of any amounts required for administration, claims, reserves, and purchase of excess insurance to the participating political subdivisions.

(emphasis supplied). By the statute's plain language, risk pools are permitted to incur reasonable expenses to administer the program and must maintain adequate funds to pay all claims, incurred but not reported claims ("IBNR") and any necessary re-insurance coverage in order to provide the coverages promised to the Members. However, it is equally clear that these are the only funds a 5-B Pool is permitted to maintain; "all earnings and surplus in excess" of these "required" funds must be returned to the Members. *Id.* No part of the statute allows, for example, a 5-B Pool to retain excess net assets in order to do away with reinsurance.[8]

Indeed, R.S.A. 5-B:5, I(f) explicitly requires an annual actuarial evaluation to assess "the adequacy of contributions required to fund [the pooled risk management] program and the reserves necessary to be maintained to meet expenses of all incurred and incurred but not reported claims and other projected needs of the plan." (emphasis supplied). Read together, these two provisions of R.S.A. 5-B leave no room for the Respondents' argument that the appropriate level of net assets rests solely in the discretion of the Board.

First, the statute expressly requires the return of all excess "earnings and surplus" to the Members. Net assets (also known as capital or Member Balance) are, by definition, earnings and surplus. Net assets may be considered above and beyond funds set aside for administration, claims and reserves. HT 1263-71, 1526. Thus, the statute could reasonably be read to mandate the return to the Members of all net assets as "earnings and surplus" in excess of required "administration, claims, [and] reserves." Although the Bureau reserves the right to argue this interpretation on appeal, should one be necessary, for purposes of this proceeding, the Bureau allows that some amount of net assets falls under the actuarial calculation of funds needed to absorb unexpected costs to satisfy the obligations of the pooled risk management program to its Members. The critical question here then is what amount of net assets is actuarially appropriate.

Second, the statute expressly requires that the actuary evaluate the pooled risk management program, RSA 5-B:5, I(f), and provides the "evaluation shall assess the adequacy of contributions required to fund any such program and the reserves necessary to be maintained to meet expenses of all incurred and incurred but not reported claims and other projected needs of

[8] LGC has transferred external reinsurance charges to an internal 4.2% claims pooling fee in order to increase net assets. HT 1343-45. Nevertheless, the LGC Bylaws require the Executive Director to maintain reinsurance coverage. *See* Exh. LGC 222 at § 8.3.

the plan." *Id.* Inclusion of this provision demonstrates the intent to remove discretion from the Board. While the Board must establish the amount of contributions "required" to operate the risk pool, the Board must do so in reliance upon the specific actuarial calculation of "required" funds. The Board's job is to set the lines of coverages to be offered to the Members, as well as to establish other programmatical offerings such as risk management workshops, and then ask a qualified actuary to calculate the "required" contributions. Through the interplay of Section 5-B, I(c) and (f), it is clear that the statute does not permit the Board to exercise unlimited discretion over the amount of contributions needed to fund the risk pools. The Board's decision making must be tethered to sound actuarial calculation and the actuarially calculated amount "required" to pay claims, IBNR and the projected needs of the plan is determinative, because any additional funds are excess "earnings and surplus" that must be returned to the Members.

This careful restriction on amassing excess net assets is both consistent with the nature and purpose of 5-B risk pools and with the LGC Board's own discussions. It also distinguishes New Hampshire's risk pools from the private for profit and not-for-profit insurers cited in the studies presented by the Respondents. Unlike insurance companies, 5-B risk pools are "like a cooperative. It's member driven, it's member managed, it's member run. It's for the members." HT 1613 (McCue). Consequently, any net assets "belonged to the members." HT 411-12 (Andrews).[9] Indeed, at least in 2001, the LGC Board understood that amassing excess net assets above and beyond what was actuarially required was improper under R.S.A. 5-B.[10] Thus, under the statute, LGC (and other 5-B risk pools) may not retain net assets in excess of amounts

[9] LGC actuary Peter Reimers also agreed that "net assets legally belong to the members of the Local Government Center." HT 1337.

[10] HT 471-81 (Mr. Andrews discussing 2001 bill sponsored by LGC to strip Primex of net assets because LGC board members believed it was public money in "excess of what was required to meet actuarial standards" and should not be held by a 5-B pool). *See* Exh. BSR 22.

required by actuarial standards, and the actuarially determined amount of required net assets is the maximum amount of net assets permitted by R.S.A. 5-B:5.

At the hearing, and through its experts' reports, the Bureau demonstrated that the amount of net assets required by actuarial standards is in the range of an RBC of 2.1.[11] Specifically, Mr. Atkinson, a healthcare actuary specializing in the calculation of reserves and net assets, HT 645-648, performed a specific calculation to "to determine an actuarially appropriate level of capital or net assets for the Local Government Center." HT 652. Using LGC's audited financials and a complex modeling approach called "stochastic modeling," Mr. Atkinson established that the actuarially appropriate level of net assets for LGC in 2010 was $41.4 million[12] at a 95% confidence interval.[13] HT 652, 657; Exh. BSR 12.

Similarly, Mr. Coutu, a runoff specialist in the insurance field, HT 77, performed a balance sheet analysis of HealthTrust's claims manifestation period and the maturity dates of HealthTrust's investments that confirmed Mr. Atkinson's opinions. HT 140-150, 156. Mr. Coutu determined that HealthTrust is a "very short tail line," HT 146, meaning that the "preponderance of the claims . . . came in during the policy period," and "after one year following the policy period, there was no statistically significant claims filed." HT 142-43. Accordingly, Mr. Coutu reached an opinion that net assets invested with maturities greater than one year were necessarily excess net assets not needed by HealthTrust to cover claims when they become payable. HT 150, 157-58. In 2010, HealthTrust held $35.7 million of its net assets in

[11] RBC stands for "risk based capital" and is an indexing tool created by the National Association of Insurance Commissioners ("NAIC") to provide a standardized relative measure of capital related to the risk associated with insurance pools.

[12] $41.1 million is slightly less than an RBC of 2.1, or half of LGC's target RBC of 4.2 ($84 million).

[13] A 95% Confidence interval means that the model will be accurate 95% of the time (*i.e.*, the capital actually required will be at or below the actuarially calculated level). HT 656-57. In the other cases occurring 5% of time, the capital actually required will exceed the actuarially calculated level by a penny or more, with a greater likelihood that the amount the capital exceeds the projection is closer to a penny than to a larger amount. HT 657-58.

long-term (greater than one year maturity) investments.[14] HT 225 & Exh. BSR 9. These long-term net assets are necessarily excess net assets not needed to pay claims. HT 226. Through simple mathematics, Mr. Coutu demonstrated that returning HealthTrust's $35.7 million in excess net assets in 2010 would have resulted in remaining net assets of $47.7 million, HT 226, which corresponds to an RBC of approximately 2.4.[15] HT 229 & Exh. BSR 71.

Mr. Coutu also explained the National Association of Insurance Commissioner's (NAIC) RBC actuarially determined rating formula focused on an RBC of 2.0. HT 83. Using this method, he found that in 2010, the LGC held $43,706,00 in excess net assets or surplus. HT 220. Mr. Coutu also explained that the LGC HealthTrust program was not subject to the additional stress test referred to as the "trend test" which would have boosted the required assets to an RBC of 3.0. HT 371-73. Finally, it is important to note that the LGC was at 2.1 RBC in 2002 when it decide to double its holding of net assets. Exh. BSR 66 at 207.

Critically, Respondents presented no alternative to the Bureau's RBC 2.1 calculation of the actuarially appropriate level of net assets to meet HealthTrust's needs. HealthTrust's actuary, Peter Reimer, never provided (to the LGC Board or to the Presiding Officer) an assessment of an actuarially required level of net assets. Rather, Mr. Reimer repeatedly stated, in testimony and in his written report, that the target level of net assets was set by the Board based on a comparison with private and non-profit insurance companies in a variety of states other than New Hampshire. HT 1256, 1262-63, 1271-77, 1331-32, Exh. LGC 269 at 2, 4, 6. At most, Mr. Reimer opined that the Board's chosen RBC of 4.2 was a "reasonable, prudent target capital level," HT 1317, but Mr. Reimer never opined that it was an actuarially required or actuarially

[14] "[F]or a healthcare short tail company to have investments going out five to ten years, in this case ten-plus years, is, (a) unusual; and (b), since those securities have such a long investment maturity date, it tells me that the – HealthTrust is not anticipating needing those funds in the short run. The short run is defined as 12 months from the statement date." HT 157-58.

[15] Ms. Keeffe testified that LGC Property-Liability Trust held $3.1 million of excess net assets (surplus). HT 1533.

determined level of net assets.[16] In fact, Mr. Reimer testified that he does not know where 4.2 came from, but speculates it relates to the older 20% corridor of claims not covered by reinsurance that kicked in at 120% of expected claims. HT 1330-31.

The fundamental flaw in Mr. Reimer's opinion, and in the approach taken by the LGC Board, was the failure to give proper meaning to the specific requirements of R.S.A. 5-B:5, that the actuary calculate the actuarially required level of funds, R.S.A. 5-B:5, I(f), and that any excess earnings and surplus be returned to the Members, R.S.A. 5-B:5, I(c). As set out above, the statute imposes a cap on retained net assets, and leaves no discretion for the Board to decide that it prefers to retain excess Member funds for unnecessary risk pool functions.

Mr. Reimer's misunderstanding of the statute is exemplified by his explanation in his report of how LGC sets its target level of net assets:

> "LGC-HealthTrust uses the RBC method to determine a <u>minimum</u> reserve; it then sets a target reserve, expressed as an RBC ratio, by reference to other health insurance programs and statutory limits on maximum reserves, with due regard for differences between LGC-HealthTrust and other insurers. The target RBC ratio is <u>set by the Board</u>, and is reviewed on an ongoing basis."

Exh. LGC 269 at 3-4. Rather than support LGC's attack on the Bureau's analysis, Mr. Reimer actually proves the Bureau's point. Mr. Reimer acknowledges that an RBC near 2.0 is the appropriate minimum actuarially sound level of net assets. *Id*. Because R.S.A. 5-B requires a return of any earnings and surplus that exceed amounts actuarially <u>required</u> to operate the risk pool, the <u>minimum</u> actuarially sound level of net assets is roughly equivalent to the <u>maximum</u> level of net assets allowed under the statute. While, in another context it may be desirable to maintain a greater level of net assets; due to the statutory requirement to return surplus, LGC is not permitted to accumulate net assets above a level actuarially required to operate the risk

[16] Mr. Reimer agreed that "whether we choose 4.2. or we choose 4.8 or 6.8, there's really nothing special about that number. It just back into a goal for the amount of net assets this enterprise decides it wants to hold." Ht 1335.

pool.[17] *See* HT 321-22. ("[W]ere [it] not for the statutory requirement of returning excess surplus, the amount of surplus being very high is not a bad thing.") (Coutu).

In summary, the plain language of the statute requires that a 5-B risk pool maintain no more than the amount of net assets required to operate the risk pool, as established annually by an actuary. The Respondents have improperly decided that they may increase Member contributions in order to collect and retain an additional amount of net assets that are discretionary, rather than actuarially required. This constitutes a violation of the statute. The Bureau has established that the actuarially required level of net assets is an RBC of 2.1 or a 95% confidence level in stochastic modeling, and Respondents have failed to present an actuarially calculate alternative level. For these reasons, the Bureau respectfully requests that the Presiding Officer find that the Respondents are operating in violation of R.S.A. 5-B:5, I(c) and (f); set an actuarially sound maximum level of net assets at RBC 2.1; and order Respondents to immediately return excess net assets (surplus) the Members of each risk pool.[18]

B. <u>Improper uses of excess net assets that should have been returned to the Members</u>

After raising rates to amass millions of dollars of excess net assets, supposedly to protect against unexpected claims, the Respondents transferred approximately $31 millions of dollars of Member contributions to LGC Parent for large "potential" administrative expenses, HT 1514, and to subsidize a failing workers compensation pool in order to compete with Primex. HT 492. In addition, the LGC Board transferred millions of dollars worth of real estate paid for by the risk pools to LGC Parent, without compensating the pools. HT 445-46. These improper uses of

[17] Indeed, evidence at the hearing demonstrated that LGC already has built in factors to account for variance in claims and IBNR that reduce the likelihood that net assets would be needed when claims and IBRN exceed projections. HT 683-84, 1347. *See also* Exh. LGC 177 (discussing LGC's "conservative reserve" for IBNR, the 1% risk charge component, and a trend add-on). In addition, because HealthTrust is such a large pool ($392 million in 2010 contributions, HT 124), claims fluctuations are smaller and more predictable, thereby reducing the need for large amounts of net assets. HT 677.

[18] Ms. Keeffe testified that LGC could calculate a return of excess net assets to members. HT 1556-58.

Member contributions for non-risk pool purposes violate the purpose of R.S.A. 5-B and constitute excess net assets that should have been returned to the Members.

It is uncontroverted that the LGC Board voted to subsidize the Workers Compensation pool (the "WC Pool") with Member contributions primarily from HealthTrust, despite the fact that the membership in HealthTrust and the WC Pool were not identical, HT 456-57, and despite prior disparagement of this practice by the LGC Board when Primex had allegedly employed it previously. HT 476-481. Rather than making the subsidy transparent or putting the plan up for a vote of the Members, HT 1537, 1858, the LGC Board disguised the subsidy as part of a strategic plan whereby annual distributions were made to LGC Parent from each pool and LGC Parent then passed a portion of the money on to the WC Pool as a direct subsidy. HT 500-501. The distributions from HealthTrust to LGC Parent for the Strategic Plan totaled $31 million between 2003 and 2010, HT 196-97, and $18.3 million was passed on to the WC Pool. HT 198.

When the Bureau began to question the subsidy and LGC Members complained, the LGC Board met, and on the recommendation of Ms. Carroll, voted to re-characterize the subsidy payments from HealthTrust as a loan. HT 1841. Ms. Carroll suggested a note with interest,[19] but the LGC Board instead crafted a no-interest note with no date of first payment and repayment schedule.[20] HT 1221-1225. Mr. Curro voted against any note acknowledging the debt. Exh. BSR 66 at 603. Moreover, repayment is required only when the WC Pool has excess net assets; an eventuality that has not yet occurred and the date of which the LGC Board chair acknowledged he cannot project. HT 1223.

The WC Pool has directly benefitted from the subsidy, and Ms. Carroll agreed that the WC Pool "could not have gotten to its current status without the payment of those subsidies over

[19] Indeed, LGC has an intercompany loan policy that provides for interest. HT 1542.

[20] Mr. Curro voted in favor of the subsidy scheme, but voted against providing HealthTrust with a note for its payments to the WC Pool. HT 1543.

the years from ‘04 through ‘10.” HT 1860. Accordingly, the WC Pool currently benefits from the unjust enrichment of the subsidy payments from HealthTrust.[21] Because the WC Pool merged with the Property Liability Trust in 2007, the Property Liability Trust now holds the improper $18.2 million subsidy in its combined assets. HT 1668. In light of the unjust enrichment and the note executed by the LGC Board, these assets are held in a constructive trust for HealthTrust. *See* Clapp v. Goffstown School District, 159 N.H. 206, 210-11 (2009) (relying on the Restatement (Third) of Restitution and Unjust Enrichment); Lamkin v. Hill, 120 N.H. 547, 551-52 (1980). *See also* Restatement (Third) of Restitution and Unjust Enrichment, §§ 1, 2, 41. The Bureau respectfully requests that the Presiding Officer order the LGC Property Liability Trust to disgorge the $18.2 million subsidy from the combined LGC Property Liability Trust,[22] and order its immediate return to HealthTrust as restitution where it will become eligible for return to Members as excess net assets.[23]

In addition to the illegal subsidy, the Respondents improperly transferred ownership of the LGC real estate from HealthTrust and Property-Liability Trust to LGC Real Estate without compensation to the risk pools. HT 212, 1036-37. Prior to the transfer, HealthTrust held approximately 75% interest in the real estate, and Property-Liability Trust the remaining 25%. HT 211, 445. The Respondents’ argument that the risk pools received compensation in the form of reduced rents was disproved by the fact that all of the LGC entities are charged rent on the same reduced cost basis, and LGC Real Estate retains the rents of other non-LGC tenants. HT 1038, 1530-31. Mr. Andrews conceded that “HealthTrust doesn’t get a particular benefit in its

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[21] The Property Liability Trust also made subsidy payment to the WC Pool (through LGC Parent), however, because Property Liability Trust and the WC Pool merged in 2007, no return of the subsidy is warranted.

[22] Attorney McCue acknowledged that the combined assets of Property Liability Trust and the WC Pool are legally available.

[23] In the alternative, the Bureau requests an order disgorging the admitted amount of the note, $17.1 million. Exh. BSR 66 at 601-603.

share of the costs because it contributed the overwhelming value of the building to the enterprise." HT 449. Ms. Keeffe confirmed this to Kevin Bannon. HT 1036-38. The current value of the real estate is approximately $10 million. HT 214. Like the WC Pool, LGC Real Estate has been unjustly enriched, and title to the real estate should be returned to HealthTrust and Property-Liability Trust in the original 75/25 proportion. The risk pools should not be required to pay rent to utilize real estate that they own, and they should receive the benefit of lease agreements with other LGC and non-LGC tenants.

C. <u>LGC's rate credit method to return surplus violates R.S.A. 5-B and facilitates violations of municipal budget laws.</u>

The Respondents' 2007 change to an actuarial rate adjustment to return excess net assets to Members does not satisfy the intent of the return of surplus mandate and facilitated the unknowing violation of municipal budget laws by LGC's Members. The Bureau incorporates and restates here the legal arguments set forth in its Omnibus Objection to Respondents' Dispositive Motions.

Fundamental flaws in the Respondents' rate credit system are its discretionary nature and built in recapture mechanism. First, rather than return excess net assets to Members whenever they exist at the end of a given year, the LGC Board gave itself unfettered discretion to determine when to apply excess net assets to the rate credit system for return to the Members. Exh. BSR 67 at 15-16, §§ 5.1 and 5.2. As set out above, the statute does not allow the Board any discretion to decide to retain excess net assets, which must be returned to Members. Second, by spreading the return of excess net assets across a three-year period, HT 415, and recalculating the magnitude of excess net assets to be applied to rate credits after each of those three years, the LGC maintains the discretion to take back excess net assets from year one to cover perceived needs in years two or three. HT 421. Thus, a portion of the excess net assets may never be returned to the Members.[24]

Contrary to the Respondents' system, excess net assets should be returned to Members on an annual basis. This is consistent with municipal budgeting cycles and statutory restrictions on carrying funds over multiple years which were in existence and presumably known to legislators when RSA 5-B was adopted. For example, in order to hold appropriated funds for more than one budget cycle (a year), towns, cities, and school districts must created non-lapsing funds by vote of the appropriate authorizing body. HT 539-42, 1231. *See also* RSA RSA 34:1 and 1-a (capital and non-capital reserve funds for cities); R.S.A. 35:1 and1-c (capital and non-capital reserve or trust funds for municipalities and counties) and R.S.A. 198:20-c, I and III (school districts' maintenance of trust funds specifically allowing for funds to pay health care costs and health insurance premiums). The form participation agreements in evidence propose a form resolution to be adopted by the participating Members. Exh. BSR 61 at 47-48. Nothing in the draft resolution suggests that Members obtain the required votes at town meeting or the equivalent to allow funds to be reserved beyond the fiscal year.

While administrators and elected officials who sit on the LGC Board may prefer a rate credit system because it obviates their need to set up non-lapsing funds or to account for returns of budgeted appropriations, the Respondents are not permitted to violate the statute merely because a few Members' representatives would find it more convenient. Municipal budget laws serve important representational and protective purposes that should not be sidestepped by allowing LGC to retain Member funds that should be accounted for and returned to Members to be put to appropriate municipal priorities. In order to put the funds back into the Members' hands where they are needed most, return of excess net assets should be done on an annual basis.

[24] In addition, Members who leave LGC are no longer eligible to receive a return of excess net assets, even though their contributions are part of the excess net assets.

III. Counts III-V – Violations of the Uniform Securities Act

Counts III through V of the Bureau's Amended Petition allege violations of New Hampshire's Uniform Securities Act, R.S.A. ch. 421-B. Specifically, Count III alleges that the participation agreements sold by the Respondents are securities under R.S.A. 421-B and Respondents must, therefore, comply with the requirements of the Act. Flowing from the status of Participation Agreements as securities are a series of violations of the Act, including failing to register the Participation Agreements as securities with the Secretary of State (Count III); offering, issuing, and/or selling Participation Agreements without being licensed as broker-dealers, issuer-dealers, or agents (Count III); knowingly or negligently aiding LGC employees whom Respondents directly or indirectly controlled, in selling unregistered securities (Count IV); and committing securities violations through material omissions in connection with the offer or sale of Participation Agreements (Count V). The Bureau incorporates and restates here the legal arguments set forth in its Omnibus Objection to Respondents' Dispositive Motions.

A. LGC Participation Agreements are securities under New Hampshire law.

The fundamental test for whether the Participation Agreements are securities under New Hampshire law is the *Howey* test, established by the United States Supreme Court in SEC v. W.J. Howey Co., 328 U.S. 293 (1946). HT 2083 (Murphy). LGC Participation Agreements satisfy each of the four prongs of the *Howey* test: (1) investment of money; (2) common enterprise; (3) expectation of profits; and (4) efforts of others. *See* Omnibus Obj. at 33-40 for more detailed description of the *Howey* test.

First, there is little doubt that purchasing Participation Agreements constitutes an investment of money. Purchasing insurance coverage is basically a financial proposition – towns and school districts pay money in and get benefits out in the form of payment of money on claims. HT 1983 (Samuels). In addition, there is a clear investment aspect to risk pools. The 5-

B pools are pools of capital "managed both in terms of its investment and in terms of the actual risk management function." HT 899 (Fryer). Because the Members own the pool, HT 1613 (McCue), they are "both policyholders and stockholders" in the 5-B pools. Id. As owners, the Members bear "the normal risks of a stockholder" because the Members are "betting that [the pools are] going to be able to perform that risk management function . . . cheaper."[25] HT 916. In addition, the Members bear the risk and potential benefits of LGC's management of the investment of the pooled Member funds. HT at 562-63 (Andrews).

Second, there is a clear expectation of profits when Members purchase Participation Agreements with LGC.[26] LGC advertises that it invests Member contributions and returns the profits to Members as dividends or rate credits.[27] *See* Exh. LGC 209, BSR 51, BSR 58. Whether through direct payment as dividends, or an offset or rate credit, LGC returns money to its Members. HT 923 (Fryer), 1995 (Samuels). When Members understand and expect to receive a financial benefit through rate reductions, the lower rates constitute a profit under the *Howey* test. Id. Moreover, the expectation of a profit need not be the sole reason for investing in order to satisfy the *Howey* test. HT 1944-45 (Samuels).

Third, the profits or loss associated with investments in Participation Agreements are delivered through the efforts of LGC and its investment managers. There is no dispute that LGC, through investment managers, controls the investment of Member funds that result in earnings or losses. HT 562. The towns, cities, and school districts have no control over the investments. Similarly, LGC touts its expertise in providing risk management services to reduce the Members'

[25] Indeed, LGC consultant Jenny Emery explained that in contrast to an insurance company where payment of premiums is a one-off expense, contributions to a member-owned risk pool are investments with the possibility of a return when the pool members collectively have fewer (or less expensive) claims. HT at 2214-16.

[26] The common enterprise prong of the *Howey* test is undisputed, and, therefore, not discussed.

[27] Ms. Keeffe testified to the process LGC Property-Liability Trust, LLC used to calculate and return dividends to Members, and that they later switched to a rate credit system to return net assets to Members. HT 1531-32.

risk profiles. HT 1392-93. Indeed, the sheer volume of expert testimony and testimony regarding reliance on experts and consultants demonstrates that LGC is a complicated organization making highly complex decisions on how to manage Member funds. It is simply absurd to suggest, as the Respondents have, that Members play a meaningful role in determining the amount of surplus they receive through rate credits because they control their claim experience. In addition, towns, cities and school districts have at best marginal control over the frequency and magnitude of health and property-liability claims. The connection to the complicated operations of LGC that result in a return of surplus is tenuous at best.

Moreover, the Respondents presented no explicit evidence on how rate credits are adjusted to account for Member experience. While Ms. Keeffe provided a detailed explanation of how LGC previously calculated dividends based, in part on Member experience, HT 1503-10, no comparable evidence was offered to demonstrate a similar reliance on Member experience in the current rate crediting process. In fact, Ms. Parker's brief explanation of the process[28] suggests that towns with <u>higher</u> incurred claims in a surplus year would actually receive a <u>larger</u> share of the returned net assets than towns with lower incurred claims, because the proportion of the returned net assets that is allegedly credited to each Member is tied to their incurred claims.[29] HT 1413-14. Attorney Samuels acknowledged that if rate credits are applied "on the pro rata basis" then "yes, it would be solely from the efforts of others." HT 1954. There was no evidence presented that rate credits are apportioned based on Member experience to support the Respondents' argument that the Members control the return on their investments.

[28] Ms. Parker explained that the total amount of net assets determined by the Board to be returned via rate credits is converted into a percentage of projected claims and then staff apply that percentage to each Member's actual incurred claims to determine the amount of the rate credit. HT 1954 (Samuels).

[29] Ms. Parker's testimony was disputed by Mr. Bannon, who testified that Ms. Parker had previously explained to him during his forensic investigation that rate credits were applied to Members on a *pro rata* basis not connected to claims experience. HT 1031-32.

Accordingly, LGC's Participation Agreements satisfy each prong of the *Howey* test, and the Bureau's determination that they are securities under New Hampshire law should be upheld.

B. The Respondents' failed to demonstrate that classifying Participation Agreements as securities was ridiculous or beyond reasonable expectations.

It is undisputed that the Respondents never registered the Participation Agreements as securities or were licensed as broker-dealers, issuer-dealers, or agents at any time. HT 565, 567-68 (Andrews). Respondents argued vociferously at the hearing that because similar types of insurance products are not securities it would be ridiculous to find the Participation Agreements to be securities and LGC could not have anticipated such a finding. However, the Respondents ignore similar investment contracts that are securities. For example, ownership interests in Risk Retention Groups,[30] which are a form of private self insurance pool similar to 5-B pools, HT 2129 (Murphy), are defined as securities under federal law.[31] 15 U.S.C. § 3904. While Risk Retention Groups are not defined as securities under state law, their status as federal securities and their similarity to 5-B pools demonstrates, at a minimum, that the Respondents should have known to question whether Participation Agreements are securities.

Similarly, the United States Supreme Court has recognized that "the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Act unnecessary." Reeves v. Ernst & Young, 494 U.S. 56, 67 (1990). The Respondents relied on a series of no-action letters submitted by regulated insurance companies to argue that similar insurance-type products are not securities, yet unlike insurance companies, 5-B pools have been expressly exempted from regulation by the Insurance Department. This enhances the likelihood that Participation Agreements may be securities. Given the reasonable

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[30] Pursuant to 15 U.S.C. § 3901(a)(4), "'risk retention group; means any corporation or other limited liability association (A) whose primary activity consists of assuming, and spreading all, or any portion, of the liability exposure of its group members. . . ."

[31] While Risk Retention Groups are exempt securities under federal law, they are still expressly deemed securities.

potential that Participation Agreements are securities, it was Respondents' burden to seek clarification, and potentially an exemption, from the Bureau through a request for a no-action letter. HT 1964 (Samuels); 2121-23 (Murphy). It is undisputed that the Respondents did not seek a no-action letter from the Bureau.

This was particularly telling given the 2007 change to the LGC Bylaws to allow the 5-B pools to return Member funds through rate crediting. HT 1006 (Fryer).[32] By retaining excess net assets that belong to Members and providing rate reductions in future years, the Respondents further emphasized the investment nature of the Participation Agreements.[33] And, as set forth above, there was no evidence that the new rate crediting procedure is based on Member experience.[34]

C. <u>The Government instrumentality exemption does not apply to LGC Participation Agreements.</u>

Respondents argue that even if LGC Participation Agreements are securities, they should be exempt under the government instrumentality exemption. At the outset, it is important to note that it is the Respondents' burden to obtain an exemption from the Bureau through a request for a no-action letter. No such request was made. In any case, the government instrumentality exemption is inapplicable to LGC Participation Agreements. While the towns, cities, school districts, and counties that make up the Members of the risk pools are political subdivisions, they do not exercise any control over how the risk pools are operated or the decisions of the LGC Board.[35] Some board members are eligible to sit on the LGC Board because of their status as

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[32] The particular structure of a particular 5-B pool dictates whether participation agreements in that pool might reasonably be expected to be securities. HT 1006.
[33] The change in structure also created a new set of facts that are not subject to potential administrative gloss arguments. HT 2129-30.
[34] Indeed, the specific structure of how the risk pools retain, invest and return surplus could be the difference between a risk pool that is a permissible investment under New Hampshire's municipal budget laws and one that is not. *See* HT 2006-07.
[35] *See* 8 Cal. Corp. Comm'n Official Op., 1976 WL 4012 at *3 (Cal. Dept. Cop. Dec. 2, 1976).

municipal officials, but when making decisions for LGC, the board members act in their capacity as board members, not as government officials. Moreover, contrary to Mr. Murphy's example of the Massachusetts water board whose chair is appointed by the governor, HT 2143, no government body has any control over the LGC Board. Nor can LGC Board members be removed from office by any governmental body or official.[36] The LGC simply is not an instrument of the government and the government instrumentality exemption is inapplicable.

D. <u>Aiding the sale of unregistered securities and material omissions</u>

Upon a finding that the Participation Agreements are securities under New Hampshire law, each issuance, offer, or sale of Participation Agreements must comply with the Securities Act. R.S.A. 421-B:26, III-a extends liability for transactions violating the Act to any "person who directly or indirectly controls a person liable" including every "executive officer, or director of such person." Here, Ms. Carroll and Mr. Curro materially aided in the acts of LGC's employees who offered and/or sold unregistered securities and who were not licensed as broker-dealers, issuer-dealers, or agents, by directing LGC and its employees to offer and sell Participation Agreements. Therefore, Ms. Carroll and Mr. Curro are individually liable for administrative penalties to the extent that their actions were knowing or negligent. As set forth above, it was clear negligence not to consider the possibility that Participation Agreements could be securities or to seek a no-action letter from the Bureau.

In addition, the material omission of disclosures that the Participation Agreements are securities; that LGC and its directors, officers, and employees are not licensed broker-dealers, issuer-dealers, or agents as required by the Act; or that the Member contributions could be diverted from profitable investments to unprofitable uses such as subsidizing a financially failing workers' compensation pool or paying administrative expenses of other LGC entities unrelated

[36] *See* Cal. Corp. Comm'n Interpretive Op. 77/19C, 9 Cal. Corp. Comm'n Op., 1977 WL 4075 (Cal. Dept. Corp. Oct. 22, 1979)

to providing coverage to the Member,[37] each constitute separate and distinct violations of section 3 of the Act. *See* Omnibus Objection at 49-50.

For all of these reasons, the Bureau respectfully requests that the Presiding Officer rule that LGC Participation Agreement are securities under New Hampshire law, and that the Respondents have violated the provision of the Uniform Securities Act.

WHEREFORE, for the foregoing reasons the Bureau of Security Regulation respectfully requests that the Presiding Officer:

A. Find the Respondents liable for each of the violations alleged in Counts I through V of the Amended Petition;
B. Enter an Order substantially similar to the Proposed Order submitted with this memorandum; and
C. Grant such further relief as is fair and just.

Respectfully submitted,
The Bureau of Securities Regulations
State of New Hampshire
By its attorneys,
Bernstein, Shur, Sawyer & Nelson, P.A.

Dated this 4th day of June, 2012

/s/ *Andru H. Volinsky*

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I hereby swear that the foregoing trial memorandum was provided to counsel of record on the below service list electronically, this 4th day of June, 2012.

/s/ Andru H. Volinsky

[37] Diverting funds without the knowledge or consent of the Members is also a separate violation of R.S.A. 421-B:3: "Effecting transactions in the account of a customer without his or her knowledge . . ." R.S.A. 421-B:3, II(c).