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 COMBINED RESPONSE TO RESPONDENTS' POST-HEARING MEMORANDA

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 combined response to the three post-hearing memoranda filed by the Respondents.[1]

Weight of Legal Opinions

The Respondents' rely heavily on the opinion testimony of several designated, and undesignated,[2] expert attorneys presented at the hearing, suggesting that their "uncontroverted" legal opinion testimony is dispositive. However, a "witness may not testify to an opinion or conclusion which contains matters of law." Johnston by Johnston v. Lynch, 133 N.H. 79, 88 (1990) (*quoting* Saltzman v. Town of Kingston, 124 N.H. 515 at 524-25 (1984)).[3] While such testimony may be permitted in an administrative hearing, the Presiding Officer must give it appropriate weight and come to his own independent determination of what the law is prior to

[1] The Respondents filed three interlocking post-hearing memoranda, with each Respondent incorporating by reference the arguments of the other Respondents. The Bureau responds to all three collectively as they amounted to a single, unified 75-page memorandum. While the Bureau was entitled to file three separate 10-page responses, it has restricted its response to this 17 page memorandum.

[2] Attorney McCue was not designated as an expert in these proceedings, however, Respondents elicited opinion testimony on questions of law, and attempt to rely on these opinions in their post-hearing memoranda.

[3] *See also* Nieves–Villanueva v. Soto–Rivera, 133 F.3d 92, 99 (1st Cir. 1997) ("It is black-letter law that it is not for witnesses to instruct the jury as to applicable principles of law, but for the judge.") (internal quotations omitted); U.S. v. Prigmore, 243 F.3d 1, 19 (1st 2001) ("[E]xpert testimony proffered solely to establish the meaning of a law is presumptively improper.").

applying the law to the facts. As such, expert opinion on the ultimate legal questions to be answered is not dispositive.

LGC Operates Two Risk Management Pools

The crux of Respondents' arguments on Count I is that the LGC operates a single pooled risk management program and only one board of directors is, therefore, required. This argument suffers from two fatal flaws. First, it is factually inaccurate. LGC's risk pools are organized and operated as two separate legal entities with separate corporate and 5-B filings, *see* Exh. LGC 305 & 306 (R.S.A. 5-B:4's informational filing requirements for each separate risk pool management program), and LGC's own Participation Agreements admit that LGC operates "two pooled risk management programs." Exh. BSR 61 at 8. Second, the Respondents overlook the fact that neither of the legal entities that operate the two pooled risk management programs have boards of directors or bylaws. HT 1631-32 (McCue). The suggestion that the board of a third-party organization with its own set of interests can satisfy R.S.A. 5-B's requirement that each pooled risk management program have a board of directors is simply untenable for the reasons stated in the Bureau's previous briefings on this subject.

LGC Board's Fiduciary Duties

The Respondents' confuse the issue of what duties the LGC Board owes to the risk pools and the risk pool Members. It was established at the hearing that LGC Parent owes no fiduciary duties to its wholly-owned subsidiaries. HT 130, 1630. Mr. McCue's suggestion that LGC's "management obligation" to the LLCs is co-extensive with the fiduciary duty of a direct board is incorrect. Curro Memo[4] at 14 (citing HT 1630-31). A member/manager owes members of an LLC only a duty to avoid gross-negligence or willful misconduct in managing the LLC, R.S.A.

[4] References to the Respondents' post-hearing memoranda will be cited as "Curro Memo at #," "LGC Memo at #," and "Carroll Memo at #," respectively.

304-C:31, IV, while a direct board owes full fiduciary duties to act in the best interests of the LLC and its members. HT 1995 (Samuels). Nor does the claimed social accountability of LGC Board members having to explain themselves to their members of the towns and organizations come even close to a legal duty to act in the best interests of the Members of the risk pool. Curro Memo at 16. If anything, this social pressure creates a further potential conflict of interest where a Board member's town may participate in the Workers' Comp pool, for example, but not the HealthTrust pool, thereby incentivizing that Board member to support a scheme to use Member contributions from other towns to subsidize and reduce the rate paid by his or her town for workers' comp coverage. The question of social accountability also begs the question of LGC's inability to keep all of its board seats filled by active, engaged and participating members, as gauged by contemporaneous documentation, not by after the fact renditions of board activity. HT 1881. *See e.g.*, Exh. BSR 66 at 607.[5]

In addition, the Respondents' suggestion that the Bureau was required to present expert testimony to demonstrate a breach of fiduciary duty is simply incorrect. The factual elements of a fiduciary duty are not technical or specialized even when in the context of pooled risk management programs. Rather, the Bureau was free to rely on undisputed facts, that is, LGC entities held Member funds and managed them for the benefit of the Members, thereby creating a fiduciary relationship. Brzica v. Trustees of Dartmouth College, 147 N.H. 443, 447-48 (2002).

Applicability of the Business Judgment Rule and Conflicts of Interest

The Respondents repeatedly turn to the business judgment rule to excuse their conduct, arguing that so long as the Board members acted in good faith no liability can attach. The

[5] "It is important to improve engagement of all Board members including better attendance at meetings, increase participation, involvement, and attention (less use of blackberries and computers during meetings, if reasonable). It is also important for Board members to be knowledgeable about LGC operations." Minutes of the July 20, 2011 LGC Board of Directors Retreat. Exh. BSR 66 at 607.

Respondents' significantly over state the scope and applicability of the business judgment rule.[6] Fundamentally, the business judgment rule applies to the exercise of board discretion over business decisions. It does not serve as a defense to non-discretionary actions or statutory violations.[7] If LGC's corporate structure or system of returning surplus, for example, violates R.S.A. 5-B, no amount of "business judgment" by the board can remedy the statutory violation. Only compliance with the statute can remedy a statutory violation.

With respect to discretionary decisions of the board, the business judgment rule does not apply where the directors are "interested" in the transaction. R.S.A. 293-A:8.31 ("A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest."). Here, all of the members of the LGC Board have an indirect interest in any transaction involving two or more of the LGC entities governed by the board. Id. ("[A] director of the corporation has an indirect interest in a transaction if . . . (2) another entity of which he is a director . . . is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation."). The Respondents' attempts to cicumvent this fundamental principle of corporate law are without merit. The very board members who have an indirect interest in a transaction may not use their judgment to decide that the transaction is in the best interests of all parties. Rather, only a majority vote of the non-interested board members (of which there are none) or ratification by the shareholders (here the Members of the risk pools) can save a conflict of interest transaction. Id. As the United States Supreme Court made clear almost a century ago, transactions involving two entities governed by

[6] The business judgment rule has not been expressly extended to non-profit corporations in New Hampshire. Without waiving the argument, the Bureau assumes that the business judgment rule applies to the LGC Board for the purposes of this reply only.

[7] Violating a statute is, by definition, a decision lacking in business judgment. *See* Fletcher's Cyclopedia of the Law of Corporations, § 1040 ("There are a number of other situations where the business judgment rule will not be applied," including "where the directors committed . . . an illegal act . . . .").

the same board of directors must be subjected to "close scrutiny."[8] Accordingly, there is no escaping the conclusion that the LGC Board is hamstrung by the parent-subsidiary structure,[9] which forces a single board of directors to govern multiple entities with differing interests and funding sources.

The Strategic Plan Was Not in the Best Interests of the Members

The Respondents attempt to justify their decision to subsidize the Workers' Comp pool using money contributed by Members of the HealthTrust and Property-Liability Trust for the purpose of obtaining health or property-liability coverage by suggesting that subsidizing workers' comp somehow was in the best interests of all LGC members. While it may or may not have been a justifiable business decision to provide support for a failing Workers' Comp pool, it is disingenuous to suggest that it was in the best interests of the Members of the HealthTrust and Property-Liability Trust pools to use their money without their knowledge or consent to do so.[10] At a minimum, the LGC Board should have notified and/or sought input from the risk pool Members. If the strategic plan was indeed in their best interests, perhaps the Members would have been willing to voluntarily contribute to subsidize the Workers' Comp pool.[11]

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[8] Corsicana Nat. Bank of Corsicana v. Johnson, 251 U.S. 68, 90 (1919) ("The fact that the same persons were directors and managers of both corporations subjects their dealings *inter sese* to close scrutiny. That two corporations have a majority or even the whole membership of their boards of directors in common does not necessarily render transactions between them void; but transactions resulting from the agency of officers or directors acting at the same time for both must be deemed presumptively fraudulent, unless expressly authorized or ratified by the stockholders.").

[9] The built-in conflicts of interest are exemplified by the LGC Board's decision to characterize the Workers' comp subsidy as a non-interest loan over Ms. Carroll's recommendation, HT 1800-01, 1841, and in blatant disregard for the LGC's own inter-pool loan program that included interest. HT 1543. It was in the best interests of HealthTrust's Members for their subsidy payments to bear interest and for there to be a payment schedule that requires payment at some express time and date.

[10] The evidence demonstrated that towns and cities such as Dover and Portsmouth were not aware that the LGC Board was using their contributions for health coverage to subsidize the Workers' Comp pool when they demanded return of their portion of the subsidy funds. *See* Exhs BSR 53 & 54. The LGC credited the cities' concerns when the Board adopted a note to repay the subsidy. HT 1841.

[11] Mr. Andrews testified that they could have been more transparent in implementing the strategic plan. HT 500-501

Alternatively, the LGC Board could have secured a commercially reasonable loan (internally or externally) to help get the Workers' Comp pool off the ground.

The reality is that the LGC Board decided to subsidize the Workers' Comp pool in an effort to undermine Primex, not to benefit the Members. *See* HT 487, 493, 497 (Andrews admitting that "subsidizing the workers' comp. rate to shoot at Primex was adopted"); HT 2256-58, 2261 (Emery). The Respondents' *post hoc* justifications are no more persuasive than the LGC Board's hollow gesture of characterizing the subsidy as a no-interest loan with no expectation of repayment. HT 1222-23 (Enright).

Liability of Mr. Curro

Mr. Curro continues to profess his innocence for any of the actions taken by the LGC Board while he was a member of the board on the grounds that "Mr. Curro's vote on any of the challenged issues was [not] determinative or causative." Curro Memo at 20. This, however, is not the standard for liability of Mr. Curro; in fact, it is the converse. A board member may avoid liability for certain actions taken by the board only if he votes against the proposed action and his dissent is entered into the minutes. *See* Fletcher's Cyclopedia of the Law of Corporations, § 1224. His votes in favor of restructuring the LGC entities, HT 2343, to subsidize the workers' comp program, HT 2354-56, and to adopt a net asset target of RBC 4.2 all demonstrate his complicity in the actions alleged to violate R.S.A. 5-B. HT 2336-40. While Mr. Curro is the only remaining member of the LGC Board in this action, the fact is that the Bureau brought allegations against several other board members, all of whom reached settlement agreements with the Bureau. Mr. Curro is not sued as a representative of the Board, but as an individual whose conduct is representative of the improper acts taken by the Board, and who is individually liable for his actions and as a person who, in his own judgment, decided not to settle the case

against him as all other board members did.

Liability of Ms. Carroll

Similarly, Ms. Carroll played an integral part in LGC's improper activities in violation of R.S.A. 5-B. As a member of the leadership team and as General Counsel under Mr. Andrews, Ms. Carroll had a responsibility to advise Andrews, HT 1825, and later the LGC Board as interim and Executive Director. Mr. Carroll demonstrated her role in advising the Board, HT 1841, and the Board clearly relied on advice provided by Ms. Carroll and others of its myriad consultants and advisors. LGC Memo at 4-7. Ms. Carroll, however, failed to recommend corrective action for LGC's violations of R.S.A. 5-B, including overcapitalization at RBC 4.2, HT 1842, failure to return excess net assets to Members, id., returning surplus by discretionary rate stabilization, HT 1843, or utilizing a single third-party board and bylaws in a parent-subsidiary structure. HT 1844. As an executive of LGC with overall management responsibilities, Ms. Carroll is personally liable for her complicity in LGC's violations of R.S.A. 5-B.

Net Assets Must Be Based on an Actuarial Calculation of the Amount Required to Operate the Risk Pools

The Respondents have admitted repeatedly that the Board chose its target for net assets based on a comparison with insurance companies located in other states, and not based on a specific actuarial calculation of the amount of net assets required to operate the risk pools. HT 1330-31 (Reimer); HT 2339-40 (Curro); LGC Memo at 13-14 (asserting Board chose an RBC of 4.2. using its business judgment). As set forth in the Bureau's Trial Memorandum, Mr. Reimer never performed the required actuarial calculation of determining the minimum amount of net assets required to operate the risk pools. BSR Trial Memo at 8-14. The Respondents mischaracterize Mr. Atkinson's testimony on this point, claiming Atkinson acknowledged that

Mr. Reimer calculated required funds under the guise of "other projected needs of the plan," LGC Memo at 2. In fact, Mr. Atkinson was asked and agreed that the "LGC board" projected needs of the plan, including net assets, at RBC 4.2. HT 758:15-20.

Furthermore, the Respondents' contention that there is no maximum reserve level imposed by R.S.A. 5-B, LGC Memo at 3, misses the mark. The requirement to return all surplus funds to the Members acts as a cap on retained net assets, limiting the amount that the risk pools can hold to the minimum amount required to operate the pool, and restricts the Board's discretion to set a target for net assets above the actuarially calculated minimum adequate level. Indeed, Mr. Coutu's testimony, which the Respondents only partially quote, LGC Memo at 4, makes the point nicely: "It's their prerogative to set a level [of net assets] they deem prudent," . . . but "I have to raise the caveat of subject to the obligation of repatriation of excess surplus . . . ." HT 323. The statutory mandate to return excess net assets is the key to understanding the Respondents' obligations.

The Board's Choice of RBC 4.2 Was Unreasonable and Uninformed

It is clear from both the testimony presented and the Respondents' own arguments that the LGC Board relied on incorrect information in reaching its target of RBC 4.2. First, the Board exhibited a fundamental misunderstanding of the meaning of an RBC of 2.0 as the regulatory trigger point. The Respondents repeatedly conflate the initial regulatory trigger with imminent insolvency or ruin. HT 1295 (Reimer); HT 2336-37 (Curro); LGC Memo at 12-13. As demonstrated by Mr. Coutu and Mr. Atkinson, an RBC of 2.0 merely initiates regulatory oversight, it does not signal insolvency or imminent ruin. HT 83-86 (Coutu); HT 659-60 (Atkinson). In fact, a review of R.S.A. 404-F, which Respondents rely on to suggest RBC 2.0 is insufficient capital, clearly demonstrates the levels of regulatory involvement as an insurance

company's net assets decline below RBC 2.0. Specifically, R.S.A. 404-F names RBC 2.0 as the "company action level."[12] Indeed, the only regulatory involvement at RBC 2.0 is a requirement to submit an explanation of the company's plan to maintain adequate net assets going forward. Id. At RBC 1.5, the "regulatory action level," the Insurance Department begins to provide input to the company on how to maintain and replenish adequate assets. Id. It is only at RBC 1.0 where the possibility of insolvency becomes real enough that the Insurance Department has the authority to take over the company's operations. At RBC 0.7, a Department take over becomes mandatory. Id. Thus, it is clear that a substantial risk of insolvency does not enter the picture until at least RBC 1.0, and the "regulatory trigger" of RBC 2.0 is merely a reporting requirement.

Ms. Keeffe herself testified to the adequacy of LGC's net assets and ability to expand net assets when LGC's RBC dipped to 1.22 in the late 1990s. HT 1526-27. Rather than result in ruin,[13] as inferred by the Respondents, Ms. Keeffe declared that LGC's finances were healthy. HT 1519-27; Exh. LGC 199 (Memo to Members entitled "Trust Financially Sound").[14] Thus, the Respondents apparent fear of RBC 2.0 as a significant regulatory trigger or sign of imminent insolvency was misguided.[15]

In addition, the LGC Board relied on a faulty comparison to other insurance companies to

[12] Unless the company also fails the trend test which was explained in Mr. Coutu's testimony. See R.S.A. 404-F:3 and HT 371-73.

[13] Despite testifying that ruin was likely at RBC 2.0, Mr. Reimer told the LGC Board that "he is not inclined to use th[e] term[ruin]." Exh. BSR 66 at 535.

[14] Ms. Keeffe's Memo explained that "the Trust is very sound and in good financial health now and it is expected to be well into the future." Further, Ms. Keeffe explained the "Trust's Members' Balance is its free surplus, which is not associated with its reserve for claims. The Trust's financial position clearly shows it is sound and is now meeting and should in the future meet its claims reserve and other financial requirements." Exh. LGC 199.

[15] Mr. Curro, the chair of the Finance Committee, testified to his misunderstanding of RBC levels, stating that at RBC 2.0 "I believe you are near insolvency, and if it was an insurance company, they would be looking to either take you over or receivership." HT 2336-37. In fact, a "take over" or "receivership" cannot occur until RBC 1.0 and is not mandatory until RBC 0.7. R.S.A. 404-F:6. Mr. Curro also thought that at RBC 3.0 "you're on a watch list," and are "one step from getting into trouble." Id. Mr. Curro could not have acted to set net assets levels in good faith without an accurate understanding of the methodology he was using.

choose its RBC level. None of the insurance companies presented to the Board as having higher RBCs are subject to R.S.A. 5-B or the statutory requirement to return excess net assets to the Members. Without the statutory cap on net assets inherent in the return of surplus requirement, an insurance company (or pooled risk management program) would be free to maintain a higher level of net assets.

Finally, in addition to relying on incorrect and irrelevant information, the Board admits that its decision was patently arbitrary. Mr. Reimer told the LGC Board that it "is a very subjective judgment about what the rate numbers are" when using RBC. Exh. BSR 66 at 202. Mr. Atkinson's testimony made clear that Mr. Reimer's characterization was wrong in that Mr. Atkinson was able to calculate a specific level of net assets required to operate the LGC's HealthTrust using stochastic modeling. HT 653-55. School Care uses the same stochastic modeling approach to determine its required net asset level. Exh. BSR 65 at ¶ 1.17.

Mr. Curro went one step further than Mr. Reimer, stating "I think we have an arbitrary number, but a formula with national statistic 'flies' better." Exh. BSR 66 at 203. Indeed, the LGC Board essentially picked RBC 4.2 out of a hat as "pretty much just above the halfway point" of other non-5-B insurance companies. HT 2339-40.[16] While the Respondents argue that this arbitrary and unfounded decision was somehow reasonable, it is crystal clear that the Board did not rely on an actuarially calculated minimum adequate net assets level as required by the statute.

Municipal Budget Laws Are Relevant and Support Interpretation that R.S.A. 5-B Requires Annual Returns of Surplus

The Bureau is not so much asking the Presiding Officer to enforce laws not committed to

[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 backs into a goal for the amount of net assets this enterprise decides it wants to hold." Ht 1335.

his control, but to read provisions of R.S.A. 5-B in concert with related sections of the Municipal Budget Law to make sense of the two. *See e.g.,* R.S.A. 32, 35 and R.S.A. 198:20-c. A municipality must spend its entire budget in the given budget year or, absent certain exceptions, the unexpended funds are used to fund the next year's budget. Loughlin, Peter, *New Hampshire Practices Series: Local Government Law*, v. 16 §1.11, at 1-19 ("NHP") ("Unexpended or unencumbered general funds lapse at the end of the fiscal year and cannot be carried forward.") and HT 2043 (Loughlin).[17] As Mr. Loughlin wrote in his book, "The Commissioner of the Department of Revenue Administration (DRA) has the authority to delete any improper appropriation by a governmental unit." 16 NHP §1.10 at 1-18. The duty to spend the budget within the fiscal year, coupled with the DRA's authority to disallow improper municipal spending is precisely what former Representative, former Goffstown Selectman and former HealthTrust Board Member Robert Wheeler referenced during the November 21, 2003 trustees meeting, "We let [Primex] do with our [town] money what DRA will not allow." Exh. BSR 66 at 358. "[Primex has] huge financial reserves. Those of you who are involved in setting tax rates want to hold money aside. You are told you cannot do that. It is only illegal if you tell about it. You do not have the chance to have a reserve." Id. at 357. The LGC practice of holding monies in reserve to allow for multi-year rate credits violates the Municipal Budget Laws if done directly by municipalities. These provisions, requiring full annual expenditures of municipal budgets, cannot be so easily circumvented by placing the money in the hands of a third party, especially when the Bylaws of the third party make clear that the funds remain the municipality's money, so long as the municipality has not withdrawn or been terminated from participation. Exh. BSR 67 at 15, §§ 4.8 and 5.1. *See also* HT 2048 (cannot place money in the

[17] A well liked snow plow contractor who a town intends to hire again the following year could not, for example, retain unexpended funds and just apply it to the next year's plowing. HT 2046.

hands of a third party to avoid annual lapsing of appropriations). Further, municipalities must budget "in gross." This means "that all monies appropriated by the [municipality] shall be stipulated in the budget on a 'gross basis' showing revenues from all sources... as offsetting revenues to appropriations affected." 16 NHP § 1.05 at 1-12 (emphasis supplied). The Bureau contends that LGC rate credits are revenues from a source that must be listed as "offsetting" revenue against health insurance premiums if those credits are carried from year to year, as is the current LGC practice. Municipalities may avoid the duty to expend portions of their budgets during one budget cycle only if they create non-lapsing funds. *See e.g.*, R.S.A. 35:1-c or R.S.A. 198:20-c.[18]

The LGC did not introduce any testimony that it has gone to the effort to encourage towns and cities to create non-lapsing funds to hold monies to be used for multi-year rate credits. As a body that contracts with municipalities, the LGC is presumed to know and abide by the limits placed on municipalities with respect to their budgets. 16 NHP § 1.10 at 1-18 *citing McQuillin.* Reading the foregoing in concert with RSA 5-B leads one to reasonably interpret 5-B's requirement to return surplus as being a requirement to do so annually, absent compliance with the special provisions of non-lapsing funds. The fact that Portsmouth, Peterborough and North Hampton have each created non-lapsing funds for the purpose of rate stabilization are proof of this point. HT 539-42 (Andrews) and 119-20 (Coutu), respectively. The provisions of RSA 198:20-c allowing for "the school district [to] name its own trustees who may expend any funds in the [non-lapsing] trust for the payment of health claims or health insurance premiums...." evidence a specific intent by the legislature to allow school districts to hold funds, year over year, for this purpose. The parallel municipal statute, RSA 35:1-c, is not as explicit,

[18] The snow plow contractor's unexpended funds may be held year over year if kept in a non-lapsing fund established for that purpose. HT 2047.

simply allowing for any purpose not foreign to the operations of the municipality. *See also* HT 2048 (non-lapsing fund may be used for health insurance rate stabilization). There is no need for the LGC to retain rate stabilization funds for multi-year periods. Municipalities and school districts may create their own rate stabilization funds with the approval of voters. Thus, taken all together, the Bureau does not ask the Presiding Officer to enforce municipal law, but instead to read RSA 5-B:5, I (c) to require the annual return of surplus.[19]

The Risk Pool Practices Agreements

The Respondents attempt to extrapolate from the Risk Pool Practices Agreement entered into between the Bureau and Primex that an RBC of 3.0 is deemed appropriate by the Bureau. However, the RBC 3.0 figure specifically applies only to Workers' Compensation coverage at Primex, HT 1674-75, not to health coverage, which Primex agreed to discontinue. HT 1675; Exh. BSR 64. In addition, the voluntary agreement entered into by Primex and the Bureau has limited relevance to LGC, as Primex has a different corporate structure then LGC. HT 1676-77. Moreover, the agreed upon method of returning between $16 and $24 million to Primex Members, namely rate holidays, is fundamentally different from rate credits employed by LGC, which are expressly prohibited under the Primex Agreement. HT 1678; Exh. BSR 64 at ¶¶ 3.5-4.0. Rate holidays are readily calculated and finite. If the Presiding Officer requires a valid comparison, School Care has agreed to use the 95% stochastic modeling method to compute net assets for its health insurance program. Exh. BSR 65 at ¶ 3.2. Finally, the Risk Pool Practices Agreements do not exempt Primex or SchoolCare from regulation under the Securities Act; the Agreements are silent on whether participation agreements in either risk pool are securities. Exhs. BSR 64 & 65.

[19] The Bureau's position is further supported by R.S.A. 5-B's requirements for annual budgeting and annual completions of actuarial evaluations and filing of annual financial statements.

The Bureau's Securities Claims Are Supported by Testimony and Applicable Law

The Respondents make a number of false or misleading statements in their attack on the Bureau's Securities claims. For example, the Respondents frequently point to no-action letters issued by the SEC or the Bureau as having relevant precedential effect. This is a gross over statement. No-action letters are fact-specific analyses of individual instruments and apply only to the single instrument reviewed and only if the factual assertions made by the entity seeking a no-action letter are accurate and continue to be accurate. For example, the Respondents state that the Bureau "previously held that instruments which cannot be transferred or hypothecated are not securities," suggesting that this "holding" should apply to LGC's Participation Agreements. Carroll Memo at 8, fn. 7. However, the no-action letter relied upon by Respondents specifically limits the scope of the letter to the facts reviewed:

> Because this position is based on the representations made in your letter, it should be noted that any different fact or condition might require a different conclusion. The staff's position is applicable only so long as the transaction proceeds exactly as set out in your letter. Different facts or circumstances might, and often would, require a different response. Further, this reply should not be interpreted as the Bureau's ruling on the accuracy or completeness of the information submitted. This response only expresses the Bureau's position on enforcement action and does not purport to express any legal conclusions on the questions presented nor any opinion or conclusion concerning any aspect of the contemplated transactions.

October 28, 2002 BSR No-Action Letter issued to Associated Pharmacies, Inc. (referenced in Ms. Carroll's March 12, 2011 Motion to Dismiss and submitted therewith as "Noncaselaw Authority") (emphasis added). Moreover, no-action letters contain no analysis of securities law that can be relied on in other factual circumstances. Rather, no-action letters simply state that a certain set of facts, as represented by the requesting entity, will not give rise to an enforcement action. *See* id. As made clear in the letter, no-action letters are fact specific and do not establish the law or policy applicable to other securities.

The Respondents also claim that the Bureau "has yet to cite a single case" establishing the lack of regulation is pertinent to the *Howey* test. Again, this is incorrect. The Bureau elicited testimony from the Respondents' expert, Attorney Murphy, that comprehensive regulation by an Insurance Department is a factor in determining whether an instrument was a security "has been referred to by the United States Supreme Court." HT 2125. Indeed, the Bureau specifically cited the case of Reeves v. Ernst & Young, 494 U.S. 56, 67 (1990), in its trial memorandum, which establishes that the absence of comprehensive regulation makes it more likely that an instrument is a security subject to securities regulation. BSR Memo at 22-23.

The Respondents frequently misstate and confuse the opinions offered by Attorney Fryer. For example, the Respondents claim that Attorney Fryer opined that the "form of surplus return is irrelevant." Carroll Memo at 12. In actuality, Attorney Fryer noted that rate credits constitute a form of profit under the *Howey* test, Exh. BSR 68C at ¶ 6(e), and further stated that whether rate credits are returned on a *pro rata* basis or based on claims experience is relevant to the securities analysis. HT 997-98.[20] Similarly, the Respondents misstate Attorney Fryer's testimony, claiming that he "could not recall whether he reviewed a participation agreement," where Attorney Fryer's actual testimony was "Yes, I know I looked at at least one participation agreement." HT 953.

The Respondents further misstate the evidence presented with regard to the expectation of profit prong of *Howey*. The Respondents claim that Mr. Coutu did not testify to an expectation of profit, having only testified "that it was the cost of health insurance" that

[20] As set forth in the Bureau's trial memorandum, there was no evidence in the record to demonstrate how LGC apportions the return of surplus through rate credits. BSR Memo at 21. Instead, Respondents continue to point to the calculation used to compute and pay dividends under the LGC's prior policy of direct repayment. *See* Carroll Memo at 17-18. The defunct dividend payment system is completely irrelevant to the LGC's current rate credit system, which is apparently based on an actuarial analysis and has not been fully explained in these proceedings. Id.

motivated North Hampton to join HealthTrust. Carroll Memo at 13. Yet a reduction in cost compared to the market, over time on a long-term basis, is precisely the "profit" contemplated by *Howey*. HT 966-67 (Fryer). Similarly, the Respondents overstate the relevance of the *Forman* decision,[21] suggesting that the fact that the *Forman* tenants "were also motivated by cost considerations, in their case the prospect of lower, subsidized rent" somehow defeats the argument that reduced cost can satisfy the "profit" prong of the *Howey* test. Carroll Memo at 14-15. The *Forman* Court, however, focused on the fact that State subsidies did not "result from the managerial efforts of others," as the basis for finding the instruments were not securities. 421 U.S. at 855. In the instant case, by contrast, LGC's conscious decision to retain surplus, invest it, and use the funds for capital expenditures, in violation of 5-B:5, I(c), meant the members of LGC's risk pools were investing money for a profit. *Forman* properly stands for the proposition that "profit may be derived from the income yielded by an investment as well as from capital appreciation." Id.[22] Inducements in LGC materials issued to the public created a reasonable expectation that such income would be returned under R.S.A. 5-B's requirement to return all excess surplus to the Members.

Finally, the Respondents attempt to expand the effect of a finding that LGC Participation Agreements are securities into a cataclysmic event with national significant. This is pure fear mongering. As stated repeatedly, findings on securities are extremely fact specific and have

[21] United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

[22] The Respondents also rely on Sec. & Exch. Comm'n v. Energy Group of Am., Inc., 459 F. Supp 1234, 1239 (S.D.N.Y. 1978) in support of their arguments, but *Energy Group of America* is completely distinguishable from the instant case. The fee paid to *Energy Group of America* was simply a fee for assistance in negotiating the process of submitting a bid for oil and gas leases – "a fee for which certain services are provided in return," and the case dealt with a lottery system. *Energy Group*, 459 F. Supp. at 1240. There was no use of membership or other fees for investment as is the case with LGC's Participation Agreements. Furthermore, the court found no common enterprise because "there [was] no common ownership of any enterprise: and there was "no entrusting of the enterprise to the management of others." Id.

minimal precedential effect, particularly outside the state of issuance. *See* HT 2129-31 (Murphy). As Attorney Fryer indicated is his testimony, to create a securities issue under R.S.A. 5-B "it would have to be the particular structure presented to me that would make the difference on whether I sought clarification [from the Bureau]." HT 1006:17-19. This point highlights an issue that cuts to the heart of the Bureau's securities argument. The question presented is not whether participation in a 5-B entity, by its very statutory nature, is an investment contract and thus a security, but instead whether the violative structure and operation of LGC in particular made the LGC Participation Agreements securities.

Indeed, a finding of a security would not necessarily apply to other New Hampshire risk pools, as they operate differently and have different participation agreements with their Members. For example, the other New Hampshire risk pools have agreed to repatriate excess net assets. Exhs. BSR 64 & 65.[23] Similarly, LGC would have the option of altering its practices to avoid its participation agreements qualifying as securities, and/or seeking an exemption from the Bureau from some of the requirement that the Respondents claim would be "devastating to pools in New Hampshire and would cost taxpayers dearly." Carroll Memo at 24.[24]

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.

[23] As stated above, the Risk Pool Practices Agreements are silent on whether participation agreements in either risk pool is a security, and do not exempt either risk pool from regulation under the Securities Act.
[24] Requesting an exemption is LGC's responsibility.

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

Dated this 7th day of June, 2012

/s/ *Andru H. Volinsky*

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Certificate

I hereby certify that the foregoing combined response memorandum was provided to counsel of record on the below service list electronically, this 7th day of June, 2012.

/s/ Andru H. Volinsky