STATE OF NEW HAMPSHIRE
DEPARTMENT OF STATE
BUREAU OF SECURITIES REGULATION

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

ANSWER OF LGC RESPONDENTS TO THE BUREAU OF SECURITIES REGULATION'S AMENDED PETITION

Local Government Center, Inc., Local Government Center Real Estate, Inc., Local Government Center HealthTrust, LLC, Local Government Center Property-Liability Trust, LLC, HealthTrust, Inc., New Hampshire Municipal Association Property-Liability Trust, Inc., LGC-HT, LLC, and Local Government Center Workers' Compensation Trust, LLC (collectively, "LGC") answer the Amended Petition filed by the Bureau of Securities Regulation (the "Bureau"), as follows. LGC provides this Answer in narrative form, responding to the general claims made in the Amended Petition rather than rebutting each sentence of that document, believing that to be more useful to the process. LGC can provide an answer in a sentence-by-sentence format, however, if preferred by the Presiding Officer.

Introduction (¶ 1)

Paragraph 1 of the Amended Petition contains general, introductory material to which no response is required. LGC nevertheless supplements the Bureau's statements as follows:

LGC is a non-profit organization, governed by an active Board of Directors made of up local, municipal, school, and county representatives, including elected officials, employees, and management. As a supportive resource for local governments, LGC provides programs and services that strengthen the ability of New Hampshire municipalities, schools, and county

governments to serve the public. Legal support, legislative advocacy, training programs, and pooled risk management services are a few examples of LGC's offerings.

The Bureau initiated an investigation of LGC in July 2009, in response to a complaint from the Professional Fire Fighters of Hampton, NH. The investigation culminated in the Staff Petition of September 2, 2011.

The Bureau filed an Amended Petition on February 17, 2012. The Bureau's Amended Petition is an attack on organizations that have faithfully and successfully served the needs of local governments throughout this state, mounting claims that have never been made before, concerning actions that were taken long ago, which were consistent with practices throughout the industry, and which were periodically reported to the Secretary of State and publicly disclosed. The motivations for such claims may be murky; but they are at least significantly wrong on the facts and the law, and a waste of taxpayer money and time.

LGC looks forward to disposing of the claims, either through dispositive motions, or following the hearing on the merits, currently scheduled to begin on April 30, 2012. Through this Answer, LGC rebuts the specific factual and legal assertions made by the Bureau, and provides a summary of the defenses and affirmative defenses it intends to mount in advance of and during the merits hearing.

Parties (¶¶ 2-21)

Paragraphs 2-21 of the Amended Petition contain general, introductory material to which no response is required. LGC nevertheless supplements the Bureau's statements as follows:

LGC (the term used throughout this pleading to describe all the corporate and LLC entities, collectively) provides various programs and services to its members, who are municipal governments and other political subdivisions within the State of New Hampshire. LGC serves

its members as a catalyst for dialogue and action; an advocate on issues; a provider of benefits and risk management services, including education and training in skills; and a resource for information. Its Mission Statement calls for it "to strengthen the quality of its member governments and the ability of their officials and employees to serve the public."

Local Government Center, Inc. ("LGC, Inc.") has existed as a non-profit organization since 1941. Its members are New Hampshire municipalities, schools, and county governments. LGC oversees the operations of its wholly-owned subsidiaries: Local Government HealthTrust, LLC; Local Government Center Property-Liability Trust, LLC; New Hampshire Municipal Association, LLC; and Local Government Center Real Estate, Inc. Prior to July 2003, LGC's name was New Hampshire Municipal Association.

HealthTrust, Inc. was established by the New Hampshire Municipal Association (now called LGC, Inc.) in 1984, during a crisis in pricing and availability of commercial insurance, in order to provide health coverage and other employee benefits to association members. From its inception, the Board governing LGC, Inc. has appointed the board of HealthTrust, Inc. In July 2003, HealthTrust, Inc. ceased to provide coverage, after it believed it had merged into a newly formed entity, HealthTrust, LLC.

Local Government Center HealthTrust, LLC ("HealthTrust") was formed in June 2003 as a single-member New Hampshire limited liability company. HealthTrust operates as a non-profit entity, with its income not subject to federal income taxation under Internal Revenue Code Section 115. HealthTrust believes that operating without profit-seeking contributes to its ability to deliver products to public sector employers and employees at lower charges than might otherwise be obtained for comparable products. It receives its operational, management, and

administrative services from its parent, LGC, Inc. HealthTrust has provided a full spectrum of employee benefits to LGC's members since July 2003.

New Hampshire Municipal Association Property-Liability Trust, Inc. ("PLT, Inc.") was established by the New Hampshire Municipal Association (now called LGC, Inc.) in 1986 in response to the lack of risk coverage available in the commercial insurance market. Its purpose was to provide property and liability coverage and risk management to association members. From the inception of PLT, Inc. the Board governing LGC, Inc. has appointed the board of PLT, Inc. In July 2003, PLT, Inc. ceased to provide coverage after it believed it had merged into a newly formed entity, Property-Liability Trust, LLC.

Local Government Center Property-Liability Trust, LLC ("Property-Liability Trust") provides property-liability, workers' compensation coverage, unemployment insurance, and risk management services to LGC's members. In June 2003, LGC, Inc. formed Property-Liability Trust, LLC as a single-member New Hampshire limited liability company. Property-Liability Trust's objectives are to formulate, develop, and administer, on behalf of LGC's members, a comprehensive risk management program, and to obtain lower costs for property-liability risk coverage. Property-Liability Trust also operates as a non-profit entity, with its income not subject to federal income taxation. The Trust receives operational, management, and administrative services from its parent organization, LGC, Inc. Property-Liability Trust has provided property and liability coverage and risk management to LGC's members since July 2003.

LGC, Inc., Property-Liability Trust, Inc., and HealthTrust, Inc. jointly began a Workers' Compensation program in 2000. Between 2003 and 2007, the Workers' Compensation program

was administered as a separate risk pool (*LGC Workers' Compensation Trust, LLC*). That program was merged back into Property-Liability Trust, effective May 31, 2007.

New Hampshire Municipal Association, LLC ("NHMA") is a nonprofit, non-partisan membership organization of municipalities. It provides advocacy support for municipal governments as well as educational and training programs for local officials and employees. Advocacy activities are governed by a board comprising municipal officials from throughout New Hampshire, and represented at the State House by a staff dedicated to government affairs. NHMA's advocacy activities are funded in full by NHMA member dues.

Local Government Center Real Estate, Inc. ("Real Estate") is a New Hampshire non-profit corporation formed in 1989 to build and maintain an office building to house the operations of the LGC entities.

Regulatory Authority (¶¶ 22-23)

Creation of the Pools pre-dates RSA 5-B. As noted above, LGC created and operated health and property-liability risk pools prior to the adoption of RSA 5-B in 1987. No legislative action was necessary to permit the operation of these risk pools. Rather, in response to questions raised by the then-Commissioner of Insurance regarding whether these municipal risk pools were subject to Insurance Department regulation or taxation, the legislature adopted RSA 5-B in order to exempt these risk pools from regulation and taxation if they comply with the statutory standards. Technically, RSA 5-B is not "enabling legislation," but rather a statute which provides an exemption from Department of Insurance regulation and state taxation. The operation of LGC's risk pools at the time the legislature promulgated RSA 5-B, in 1987, takes on particular significance due to the recognition granted them in the Purpose section of the statute: "[T]he purpose of this chapter is to provide for the establishment of pooled risk management

programs *and to affirm the status of such programs established for the benefit of political subdivisions of the state.*" RSA 5-B:1 (emphasis added).

LGC makes annual filings with the Secretary of State. Since the adoption of the statute, the LGC risk pools have made an annual filing with the Secretary of State, for the purpose of providing public access to information concerning their nature and organization, including the following: a list of the risk pool's officers; a description of the coverages provided by the pools; an annual audit of financial transactions by an independent certified public accountant; a written plan of operation or bylaws; and an annual actuarial evaluation, assessing the adequacy of contributions required to fund the pooled risk management program, and the reserves necessary to meet expenses and other projected needs of the plan. That evaluation is performed by a member of the American Academy of Actuaries, qualified in the coverage area being evaluated.

The LGC pools have supplied this information to the Secretary of State each and every year since the adoption of the statute in 1987.

The Secretary lacked any regulatory authority until 2009 or any power to penalize until 2010. Prior to July 29, 2009, the Secretary of State had no regulatory or enforcement authority over the LGC pools.[1] Through a 2009 amendment, the Secretary was provided limited regulatory and enforcement authority, but no authority to impose penalties or fines. To the extent the Bureau argues that the 2009 amendment did grant it such authority, the Bureau's failure to adopt any rules or standards regarding the imposition of penalties bars it from imposing such penalties for actions that occurred prior to June 14, 2010.

The statutory authority to impose penalties and fines became effective starting June 14, 2010, with the enactment of RSA 5-B:4-a. Any attempt by the Bureau or the Secretary to

[1] The Bureau acknowledges in its Amended Petition that the State had no regulatory authority over the pools until the adoption of the recent amendment.

regulate the activities of the pools in a way that penalizes the pools for actions taken prior to June 14, 2010 is improper and unfair, and would act as a retrospective application of a law, specifically prohibited by the federal and state constitutions, as "highly injurious, oppressive, and unjust." N.H. Const. pt. I, art. 23.

Further, LGC exists in a competitive marketplace with two other risk pools, PRIMEX and SchoolCare. The Secretary has ignored a similar complaint against the other risk pools, filed with him in June 2010. The Department of State is also aware that the other RSA 5-B risk pools have testified to the legislature regarding their RSA 5-B operating practices, which are the same as, or consistent with, many of the alleged violations raised in the Petition. In selectively enforcing the statute, and selectively applying his power against LGC only, the Secretary may violate the constitutional guarantee of equal protection and "free and fair competition in the trades and industries … [which] should be protected against all monopolies and conspiracies which tend to hinder or destroy it." N.H. Const. pt. I, art. 83.

Neither the New Hampshire Municipal Association, LLC nor LGC-PLT, LLC were named as parties in the Secretary of State's Cease and Desist Order dated September 2, 2011 which initiated this proceeding. As such neither are named parties to this proceeding nor subject to the jurisdiction of this proceeding.

Facts Common to All Claims (¶¶ 24-72)

Paragraphs 24-31 contain general factual assertions by the Bureau that do not require a response.

<u>The Creation of a Holding Company to Facilitate Inter-Company Transfers (¶¶ 32-38)</u>

In response to the newly competitive environment, in 2003 the respective boards of New Hampshire Municipal Association, Property-Liability Trust, Inc., and HealthTrust, Inc. each

determined that the welfare of their respective companies, and their respective members would benefit from a restructured organization represented by a single board of directors. A plan to accomplish that was developed following long study, with input from a variety of sources, including consultants and legal counsel. The consolidation accomplished several critical goals:

- Ensured that LGC's programs remained stable and competitive for members, and maximized the efficiency of the programs by sharing resources;
- Modernized and integrated LGC's organization structure, to better adapt to the challenges faced by a public sector entity which needed to respond more quickly to member needs;
- Offered expanded service to members through packaged pricing and one-stop shopping;
- Developed a unified culture and brand; and
- Established a streamlined and more effective governance process to facilitate all of the foregoing goals.

Strategic support of the workers' compensation pool was a business judgment of the LGC Board, and a permitted pooling of risk. Following the 2003 reorganization, LGC's Board decided to fund certain strategic priorities. The decision reflects the Board's determination how to best offer several lines of coverage, and to coordinate activities related to these coverages in a cost-efficient manner, to better serve LGC's members. The activities funded as a part of that strategy include training, wellness, loss prevention across all lines of coverage, as well as assisting the workers' compensation program's competitive position in the marketplace. The decision was made following extensive due diligence and deliberation. It reflected the Board's prudent business judgment that such support allowed better administration and management of the members' long-term, total claims liability, and preserved the long-term financial sustainability of all lines of coverage in a changing marketplace.

LGC's contract to provide health coverage is entered into with the employer political subdivision, and all payments due LGC for such coverage are, thus, the responsibility of the participating political subdivision. In making the strategic contributions, however, LGC took the extra step of segregating, to the degree possible, funds attributable to the employee and retiree's share of the cost to gain access to the employer's health plan.

The Board's annual decision on rates incorporates a review of claims trends, advice from actuaries and other expert consultants, and robust discussion during board meetings. The Board makes its decision based on the best interest of LGC and its members, in fulfillment of its fiduciary duties. Over time, funding these strategic initiatives has allowed LGC to better focus on keeping employees healthy and lowering claims costs, the single most important factor in determining going-forward rates.

The strategic support of the workers' compensation pool – both the policy and the amount – has been publicly disclosed in the pools' annual filings with the Secretary of State, starting in 2004 and continuing through the 2010 fiscal year filings.

Strategic funding ended with the calendar year 2010. LGC has specifically identified the amount of the support of the workers' compensation pool as a loan by HealthTrust, and executed a note, whereby the workers' compensation pool will repay the loan over time, from operations.

RSA 5-B:5, I(c) permits the pools to retain "any amounts required for administration," without defining "administration." Permissible use of funds includes "other projected needs of the plan." RSA 5-B:5, I(f). That provision is similarly undefined. RSA 5-B:3, I specifically permits political subdivisions to develop and administer risk management programs with the purpose of "distributing, sharing, and pooling risks." Those terms are undefined. RSA 5-B:3, III permits pooled risk management programs to provide "any or all" of a multitude of coverages,

including casualty, health, and workers' compensation. In determining what coverages to offer, how to distribute and pool the risk for those coverages, what other needs the plan might face, and what amounts might be needed to administer the programs, the LGC Board was left to exercise its best business judgment. The Board did that, while selecting the best and most efficient method of accomplishing these purposes. Taking action against Board members now, years after the actions were taken and publicly disclosed, and with no rules or guidance on the subject *to this date*, would be a severe violation of fairness and due process.

Other distributions, criticized by the Bureau, were proper. The Bureau criticizes unspecified other distributions that it contends neither directly benefit, nor relate to, the operation of the LGC's 5-B pools. The LGC board, however, made the reasonable business judgment that relatively small charitable contributions and sponsorships to groups having a direct connection to the LGC's mission benefited the pools by, among other things, positively impacting the long range claims of LGC's members, building goodwill, and increasing the size and health of the pools' membership, which brings down costs. Moreover, adoption of a defined benefit plan for employees was a reasonable action in order to remain competitive in the labor market, for the long-term benefit of the LGC, its risk pools, and its members.

<u>The Failed Corporate Restructuring of LGC Entities (¶¶ 39-45)</u>

Upon the advice of legal counsel, the boards of New Hampshire Municipal Association, Property-Liability Trust, Inc., and HealthTrust, Inc. voted to restructure the existing operations into single-member, member-managed limited liability companies, with a common parent corporation. Because New Hampshire's non-profit statute (RSA 292) does not provide for merger of a Chapter 292 entity with an LLC, LGC used a technique previously employed to accomplish the desired end goal, which was to merge the existing HeathTrust and Property-

Liability corporations into the newly and validly established New Hampshire LLCs. The technique involved creating mirror image entities in Delaware, and merging them with the New Hampshire entities.

The Amended Petition implies in this section that there are mandatory corporate forms for risk pools to take, and other forms that are forbidden. LGC disputes this. The only requirement in this regard is that the pool "exist as a legal New Hampshire entity." At all times, the entities which housed the LGC risk pools existed as legal New Hampshire entities at the time they operated the risk pool. The Amended Petition is correct that, at the time of the investigation, neither HealthTrust nor Property-Liability Trust had operating agreements, as no such agreements were required by law, and in practice, such agreements are often considered extraneous when the LLC consists of a single member. In this instance, LGC, Inc., as the single member, was expressly obligated in its By-Laws to manage the pools, and did so pursuant to those written bylaws.[2]

Calculation of LGC's Reserve Fund and Maintenance of an Illegal Capital Surplus (¶¶ 46-57)

This section of the Amended Petition challenges the amounts LGC holds in its risk pool reserves. The Bureau's claims ignore history and the terms of RSA 5-B. The Bureau's attempt to impose through the administrative hearing process what the Secretary of State has refused to do by rule-making – set a method by which *all* risk pools would evaluate risk and reserves – is improper. The specific method it recommends is, furthermore, imprudent.

The Need, and Authority, for Adequate Reserves. Pooled risk management programs must maintain sufficient reserves to: (1) protect against adverse claims experience; (2) avoid

[2] As part of a broad organizational review begun in 2009 before the investigation became public, the LGC Board authorized revisions to its governance structure, and the structure of its risk pools. LGC invited the Bureau's participation and comment on that process; the Bureau declined. Since then, LGC has adopted Operating Agreements for both risk pools.

escalations in cost; (3) minimize underwriting cycle changes; and (4) provide for competitive, regulatory, and service requirements. As non-profits whose members are political subdivisions, which can only raise additional funds through taxation, risk pools lack ready access to additional capital should their reserves prove to be inadequate. New Hampshire risk pools are further constrained to only operate within the state, and thus cannot spread risk across multiple markets. Providing health care and other coverages to New Hampshire political subdivisions is, therefore, a volatile business, and adequate reserves are vital, stabilize rates, and provide participants with a measure of rate predictability.

RSA 5-B:5, I(f) provides that a risk pool's management, in consultation with a qualified actuary, shall determine the contributions required to fund (1) its program; (2) the reserves necessary to be maintained to meet expenses of all incurred and incurred but not reported claims; and (3) other projected needs of the plan. The statute imposes no specific reserve level – either minimum or maximum – but relies upon the risk pool Boards, in consultation with qualified experts, to determine the appropriate level of reserves for their pools, based on their experience and informed judgment.

New Hampshire courts have also recognized that a non-profit health service provider must maintain an adequate contingency reserve fund:

> [A] contingency reserve fund is the only protection a non-profit health service has against temporary insolvency due to large claims arising from "catastrophe, epidemic, or serious economic dislocation." Thus, a contingency reserve fund is important to a corporation's economic well-being.

NH-VT Health Serv. v. Comm'n of Ins., 122 N.H. 268, 275 (1982) (*quoting N.H.-Vermont Hosp. Serv. v. Whaland*, 114 N.H. 92, 94 (1974)).

How LGC Sets Its Reserves. The National Association of Insurance Commissioners (NAIC) together with the American Academy of Actuaries designed the "Risk Based Capital"

(RBC) formula to determine how much reserve capital an insurance company should maintain to assure solvency. This methodology is used by *both* insurance companies and risk pools across the nation. Regulatory intervention can be triggered when an insurer's RBC falls below a certain level. Many insurance companies maintain reserve levels higher than New Hampshire's risk pools.

LGC's consulting actuary annually recommends that its risk pools utilize this industry standard for determining the size of its reserves. Based on this advice, HealthTrust has chosen an RBC target ratio of 4.2 (equivalent to approximately 20% of member contributions), since 2002. This level of RBC is above the minimum reserve level that would require intervention by various insurance regulators, though below that maintained by some not-for-profit Blue Cross Blue Shield Plans (RBC of 5.5-9.5), and below levels that some experts consider justifiable (RBC of 5.5-9.0).[3] Although not applicable to risk pools, HealthTrust's reserve ratio is also consistent with that of New Hampshire law governing non-profit health service corporations, which cap reserves at 20% of annual premiums. RSA 420-A:22.

Actuarial prediction of rates necessary to cover a year's worth of claims can never be 100% accurate. In 2009, for example, HealthTrust paid out $353 million in claims and sustained an operating loss of $14 million, which was covered by its existing reserves and surplus. Even a short string of consecutive years of such adverse experience could: (1) deplete a risk pool's reserves below minimum industry standards; (2) render the pool unable to pay the health care claims of its covered individuals; (3) result in dramatic rate increases; and (4) eventually result in insolvency. Reserves necessary to cover these contingencies are vital to risk pools.

[3] The Massachusetts Division of Healthcare Finance and Policy prepared a *Study of Reserves and Surpluses of Health Insurers in Massachusetts*, discussing the appropriate maximum level of reserves. The study found that the appropriate maximum level is more than twice as high as LGC's target reserve levels, and four times as high as that recommended by the Secretary of State's actuary.

The LGC board spends a considerable amount of time reviewing reserve levels each year. There are differing opinions about the right level of reserves, yet LGC's reserves have remained within the range of reserves established by similar risk-taking programs and permitted by regulators. A regulated health insurance program with reserves at the level recommended by the Secretary of State's actuary would prompt regulatory concerns about the solvency of that program.

Public Entity Risk Pools May Take on the Characteristics of an Insurer. LGC is exempt from regulation as an insurer, by statute. The Bureau, however, erroneously and irresponsibly argues that insurance concepts and methods of evaluating risk are "irrelevant."

In fact, the cost and expense structure of a non-profit risk pool can be quite similar to that of an insurer. A November 1, 2011 report from the New Hampshire House of Representatives Committee Services Office, prepared for the House Select Committee to Study Issues Regarding the New Hampshire Local Government Center, quotes an excerpt from a text regarding Government Accounting Standards Board treatment of public entity risk pools, as follows:

> State and local governments encounter essentially the same accounting and reporting issues as commercial enterprises that provide insurance coverage (insurer) and that purchase insurance coverage (insured). … When a governmental entity is organized as a public entity risk pool, it may take on many of the characteristics of an insurer.[4]

This observation is unsurprising, for a public entity risk pool that failed to act like an insurer – setting sufficient reserves, paying claims, covering its administrative expenses – would soon fail.

Reserves are necessary to defray administrative expenses, and those expenses are consistent with industry levels. RSA 5-B:5, I(F) allows reserves for other projected needs of the plan. LGC has set aside reserves to manage yearly fluctuations in administrative costs, including

[4] *Governmental GAAP Guide 2009*, by Michael A. Crawford and D. Scot Lloyd.

necessary equipment, furnishings, and system upgrades. Administrative reserves help cushion the impact of capital expenses that arise during the year, without requiring an adjustment to the rates charged to its members.

The Key Issue on Reserves: The Absence of Statutory Requirements or Rule-Making Guidance. Though there are potentially many ways to set reserves and evaluate risks – among them RBC, chosen by LGC since 2002, and the Stochastic Method, recommended to the Legislature by the Bureau in 2011 – the key legal question for this hearing is whether LGC's Board violated some known law, rule, or applicable standard in choosing the method it did. No statute historically set the method; no rule was ever promulgated, determining the means by which those reserves should be set; and even to this day the New Hampshire Legislature continues to evaluate the report and recommendations of the Bureau on this topic, *but has yet to set a method that must be followed.* LGC and the various Respondents have, therefore, violated no actionable standard in setting reserves in the conservative and prudent manner that they did.

LGC Return of Earnings and Surplus (¶¶ 58-65)

It is common, and permitted, to return surplus through rate reduction. The Bureau, however, suggests that there is no support for this practice in RSA 5-B. Actually, the statute is silent on how surplus should be returned. Accordingly, LGC looked to the advice of its consultants and its members for the best means of returning excess funds.

Risk pools have to determine rates months in advance of the periods they cover, and then commit to those rates. Similarly, LGC's members consistently report a preference to receive excess surplus in the form of rate reduction rather than as a lump sum payment, as reduced rates allow for certainty in budgeting and administration. Indeed, returning surplus through rate reduction is the general practice of RSA 5-B risk pools in New Hampshire. Even the Segal

Report commissioned by the Bureau endorses returning amounts above that needed for reserves through rate reductions over multiple years: "Prudent underwriting would call for trying to achieve the reduction over multiple (2-3) years during the rate revisit process."[5]

The return of surplus through rate reduction was addressed in an opinion letter from LGC's attorney on April 20, 2007, which concluded as follows:

> A reduction in rating resulting from the consideration of these additional funds which reduction results in lower contributions by Members, achieves the same economic result as the dividend return to Members who then in turn must pay proportionately higher contributions. In essence, a return of additional funds to the Members has been achieved. In the absence of contrary legislative or judicial clarity on the meaning of "return" of surplus and the lack of an express legal mandate that a "return" be accomplished only by a declaration of a dividend, this method should constitute a return of additional funds to the Members within the meaning of RSA 5-B.

In that same opinion, LGC's legal counsel concluded that the return of additional funds to members through an adjustment in the ratings process, spread over a number of years to address additional unexpected contingencies, and to seek to achieve rate stabilization, was legal.

Members come and go. Together with the other RSA 5-B New Hampshire risk pools, LGC does not provide return of surplus to members who have left the pool. The statute only requires return of surplus to "participating political subdivisions," not formerly participating members who have left the pool. This is consistent with the practice of not charging members their share of the needed surplus (i.e., reserves) when they enter the pool. This practice facilitates political subdivisions shopping for the most competitive price, annually, without having to pay a large up-front "reserve payment."

[5] Segal Report, page 9.

LGC's *Post Hoc* Corporate Restructuring (¶¶ 66-68)

Unfortunately, LGC learned in August 2011 that the merger of the original New Hampshire corporations into the Delaware mirror LLCs as part of the 2003 restructuring was never effective because of a flaw in implementing the technique of simultaneous transactions.[6]

With new legal counsel assisting, LGC filed Certificates of Revival to restore the historical entities, and each entity that participated in the reorganization of 2003 ratified the 2003 transfers to the LLCs' risk pools.. This ratification took the form of a "Pooled Risk Management Agreement."

Each of the steps taken in 2011 – filing of the Certificates of Revival, the Pooled Risk Management Agreement, other ratifying acts, and corrective documents filed with the Secretary of State's Corporate Division – are well-recognized techniques for correcting inadvertent and technical errors. LGC's corporate structure is legal and appropriate, and the Bureau's assertions otherwise are illogical, unnecessarily provocative, not grounded on any regulatory violations of RSA 5-B, and generate unfortunate speculation and inefficiency.

The Conduct of the LGC Circumvents New Hampshire's Municipal Budget Laws (¶¶ 69-72)

LGC's Conduct Does Not Implicate the Municipal Budget Laws. Although the Bureau is correct in its assertions that New Hampshire municipalities are required to budget in gross, that municipal appropriations lapse at the end of the fiscal year, that off-book revenue sources are not permitted, and that municipalities are limited in the manner in which they may invest funds, its

[6] The technique requires that a New Hampshire RSA 292 corporation must first merge with a Delaware non-profit corporation, which subsequently is merged into the Delaware LLC, before the Delaware LLC is ultimately merged into the New Hampshire LLC. In 2003, the first step was omitted so that the original RSA 292 entities attempted to merge straight into Delaware LLCs. As a result of this flaw, the New Hampshire corporate entities never effectively merged into the Delaware LLCs. This flaw does not change the fact that the New Hampshire LLCs created by LGC in 2003 have always been, and continue to be, valid New Hampshire legal entities which own and operate their RSA 5-B risk pools.

assertion that LGC's conduct improperly assists its members in circumventing New Hampshire's Municipal Budget Laws is simply incorrect. Indeed, Peter J. Loughlin, Esq., one of New Hampshire's preeminent municipal lawyers and the author of the definitive treatise on the subject, *New Hampshire Practice Series: Local Government Law*, has opined that the existence of allegedly excess funds in the possession of a LGC risk pool does not result in member municipalities having illegal surplus or illegally-created non-lapsing funds in violation of the Municipal Budget Laws. In fact, unless and until such funds are actually returned to the municipalities and those municipalities exercise direct control over them, the Municipal Budget Laws are not implicated.

How LGC Invests. The Board of LGC, Inc. is a prudent and responsible manager of the assets of the risk pool programs. It periodically reviews its investment policy, the objectives of which include preservation of principal, prudent diversification, and availability of projected cash flow. The policy limits the permissible investments to meet the adopted objectives. LGC utilizes a professional investment manager and investment advisor to ensure the appropriateness of and compliance with the investment policy. While the Bureau acknowledges it is appropriate for LGC to invest its capital, the Bureau criticizes certain investment vehicles and the use of investments with a maturity of more than one year. The practices utilized by LGC related to its investment decisions are consistent with the standard of care that applies to trustees as set forth in the Uniform Prudent Investor Act, RSA 564-B:9-902, which requires that decisions respecting individual assets must be evaluated, not in isolation, but in the context of the portfolio and strategy as a whole.

Further, the nature of the risks covered by LGC can extend further than the current year. That fact affects the calculation of risk reserve. It also makes it appropriate to invest in assets

that extend further than the current year. In addition, while the investments made by LGC may contain a term longer than the current year, each of them is relatively liquid.

LGC has annually reported to the Secretary of State its investment policy, its chosen investment manager, its practice of bi-annual evaluations of the performance of the investment manager, and the nature and terms of its investments, since at least 2001. This is the first time the Secretary has taken issue with them.

CAUSES OF ACTION

COUNT I (¶¶ 73-87)

Operation of a Pooled Risk Management Program in Violation of RSA 5-B:5 --Improper Corporate Structure--

Count I charges LGC with having violated RSA 5-B:5 by having an "improper corporate structure." As explained in greater detail in its prior motion to dismiss on this point,[7] Count I fails to state a viable claim against LGC, because the Bureau identifies no statutory provision that LGC's corporate structure violates.

The Bureau declares in Count I that "R.S.A. 5-B:5, I(b) and (e) require that every pooled risk management program shall 'be governed by a board,' and by 'written bylaws,' which shall 'be filed with the department.'" Amended Petition ¶ 74. The statute does indeed impose those requirements, and LGC complies with them, it being undisputed that LGC's pooled risk management programs are "governed by a board" pursuant to "written bylaws." The Bureau, however, reads into the statute the additional requirement that each risk pool be governed by its own, *independent* board of directors and bylaws. But nothing in RSA 5-B imposes any such requirement. The Bureau's effort to read the word "independent" into the statute is unfounded, and should be rejected.

[7] *See* LGC's Motion to Dismiss Count I of the Amended Petition on the Ground that RSA 5-B Does Not Prohibit the Conduct in Which LGC Is Alleged to Have Engaged.

Indeed, the statute expressly allows for a single risk pool – which presumably would be governed by a single board of directors – to offer multiple coverages. *See* RSA 5-B:3, III ("Pooled risk management programs ... may provide any *or all* of the following coverages: [comprehensive list of coverages, including workers compensation and medical]")(emphasis added). The clear import of the language "any *or all*" in this context is that a pool may provide one *or more* of the listed coverages. If a risk pool can provide more than one type of coverage, then the statute necessarily contemplates a single board of directors overseeing multiple coverage pools – which in essence is what the Bureau objects to here. *See* RSA 5-B:5, I ("Each pooled risk management program shall . . . (b) [b]e governed by a board" – no requirement that each pool be governed by a *separate* board). The Bureau's assertion that LGC's corporate structure is contrary to "the intent and requirements of R.S.A. 5-B," because it "utilizes one single board to govern the operations of the three (3) different 5-B Pools," is unsupported by the actual text of the statute. Amended Petition ¶ 77.

In addition to charging LGC with having violated a phantom statutory provision, the Bureau claims that LGC's corporate structure violates "basic concepts of fiduciary duty and conflicts of interest." Amended Petition ¶ 77. Conspicuously absent from the Amended Petition, however, is any case law or other legal authority to support this allegation. LGC is at a loss to understand how it could be an "inherent" breach of fiduciary duty or conflict of interest principles to have structured its risk pool business in accordance with the requirements of state law. Amended Petition ¶¶ 77, 78, 85.

In sum, Count I fails because the conduct alleged therein simply is not prohibited by either the statute or by the non-specific common law principles the Bureau cites.

Further, at a minimum, as explained in greater detail in an earlier motion to dismiss,[8] Part I, Article 23 of the New Hampshire Constitution and New Hampshire common law (cited in the motion to dismiss) prohibit the Bureau from imposing penalties on LGC in connection with conduct engaged in before June 14, 2010, the effective date of RSA 5-B:4-a, which is the source of the Secretary of State's power "to investigate pooled risk management programs, issue cease and desist orders, initiate adjudicatory proceedings, impose administrative fines, and order rescission, restitution, or disgorgement." Until 2009, RSA 5-B:4 expressly provided that "[n]othing contained in this chapter shall be construed as enabling the department to exercise any rulemaking, regulatory or enforcement authority over any pooled risk management program formed or affirmed in accordance with this chapter." As RSA 5-B:4-a creates new obligations and duties with respect to violations of RSA 5-B, in the form of newly created penalties such as rescission, restitution, disgorgement, and fines, it cannot be applied to LGC retroactively.

COUNT II (¶¶ 88-104)

Operation of a Pooled Risk Management Program in Violation of RSA 5-B:5 --Failure to Return Surplus Funds to Members--

Count II alleges that LGC "has used an inappropriate actuarial method for calculating reserves" under RSA 5-B:5, and that LGC's level of reserves "exceeds prudent levels ...." (Amended Petition ¶ 92); that LGC has "failed to return surplus funds accumulated" as the statute requires (Amended Petition ¶ 94); and that LGC has "improperly inflated its administrative costs ...." (Amended Petition ¶ 95.) Unfortunately for the Bureau, RSA 5-B does not establish a required method for calculating reserves, returning surplus, or determining what administrative costs are impermissible; it simply provides that pooled risk management programs must "[r]eturn all earnings and surplus in excess of any amounts required for administration,

[8] LGC's Motion to Dismiss Counts I & II of the Amended Petition to the Extent They Allege Conduct Which Occurred Prior to June 14, 2010.

claims, reserves, and purchase of excess insurance to the participating political subdivisions." RSA 5-B-5, I(c). This is precisely what LGC has done.

As explained in greater detail in LGC's motion to dismiss,[9] if the Bureau wished to impose more exacting requirements with respect to the calculation of reserves, the proper method of returning surplus, or the determination of when administrative costs are "inflated," it should have done so via rule-making. In the absence of any rules to put LGC on notice of the particular requirements the Bureau was reading into this very general statutory language, the Bureau is in no position to create such requirements after the fact and impose them on LGC (as it seeks to do in this proceeding) with no advance notice.

The very general directive in RSA 5-B:5, I(c) -- that pooled risk management programs "[r]eturn all earnings and surplus in excess of any amounts required for administration, claims, reserves, and purchase of excess insurance to the participating political subdivisions" -- provides no guidance whatsoever as to the actuarial method to be used to assess and calculate reserves, how surplus is to be returned, or what administrative expenses are not permitted. The Bureau suggests a number of actuarial methods it believes LGC could have used, but the statute says nothing about any of these methods, and the Bureau fails to explain why the methods it suggests in the Amended Petition are statutorily permitted, whereas the method chosen by LGC is not. Nor does the Bureau explain how it knows (or how LGC could have known) that LGC's method of returning surplus somehow does not qualify as "[r]eturn[ing] ... surplus" within the meaning of the statute. Amended Petition ¶ 99. The statute lacks sufficient detail on its face for the Bureau to enforce it without first promulgating rules to provide LGC with notice of its

[9] LGC's Motion to Dismiss Count II of the Amended Petition on the Grounds that the Bureau of Securities Regulation Has Improperly Failed to Promulgate Rules under RSA 5-B, and the Statute Unconstitutionally Delegated Unlimited Legislative Authority to the Bureau and Is Unconstitutionally Vague.

interpretation of what the statute requires. The legislature itself appears to have acknowledged as much in 2010, when it enacted legislation directing the Secretary of State to provide it with "specific recommendations concerning the limitation of reserves in pooled risk management programs and the limitation on administrative expenses as a percentage of claims of pooled risk management programs." Ch. 149:6, Laws of 2010 (report was submitted, but no action has been taken by the legislature).

In effect, with Count II, the Bureau is purporting to craft its own statute, seeking to write standards into the statute which simply are not there. This effort should be rejected, as there is no basis in the statute for the lines the Bureau has drawn. LGC complied with the statutory requirements; if the Bureau wished to impose more specific obligations than are discernible from the text of the statute, it should have done so via rule-making, not by announcing new requirements for the first time in an enforcement action against LGC.

At a minimum, as explained in connection with Count I, *supra*, Part I, Article 23 of the New Hampshire Constitution and New Hampshire Supreme Court precedent prohibit the Bureau from imposing penalties on LGC in connection with conduct engaged in before June 14, 2010.

COUNT III (¶¶ 105-117)

Sale of Unregistered Securities by Unlicensed Broker-Dealers, Issuer-Dealers, and Agents in Violation of RSA 421-B:6 and 11

Count III fails for a simple reason: LGC's risk pool contracts are not securities. As explained in greater detail in LGC's motion to dismiss securities counts,[10] the risk pool contracts are not securities under the four-part test established in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (relied on by the Bureau) because they fail to meet three of four *Howey* requirements ((1)

[10] LGC's Motion to Dismiss Counts III, IV, and V of the Amended Petition on the Ground that LGC's Risk Pool Contracts Are Not Securities or are Exempt Under New Hampshire Law

an investment of money; (2) in a common enterprise; (3) with an expectation of profits; (4) solely from the efforts of the promoter or third party).

No expectation of profits. The local government entities that are members of LGC did not enter into risk pool contracts in pursuit of profit, but *to purchase risk coverage* in order to manage their risks. Although surplus may be returned to the risk pool members, either as a payment or as a structured rate reduction, the mere expectation that a portion of the money paid for risk coverage might be returned does not amount to an expectation of *profit*, but rather an expectation of a potential *rate reduction*. A rate reduction is not a "profit" within the meaning of the securities laws.

No investment of money. LGC's members paid money to LGC in exchange for a valuable benefit: risk coverage. The purchase of a good or service on contractual terms that leave the exact price to be paid undetermined is not an "investment" in the common sense of the word.

The outcome of the purported "investment" does not depend solely on the efforts of LGC. Although the financial performance of LGC's risk pools depend in part on the performance of its investments, the primary determinant of the financial performance of a risk pool is claims experience, that is, how the risks being pooled develop in a given year and how much money is paid out in claims. A risk management pool manages *risks*, which means the actual amount paid out in claims will vary from year to year. Actual claims experience is not determined by "the efforts of [LGC]," but by the number and size of claims made against each risk pool member.

As for the risk capital test, New Hampshire state cases have never applied it, and the Bureau should not be permitted to hold LGC to a newly-decreed standard. In any event, the risk pool contracts are not securities under the risk capital test, because LGC members have no expectation of receiving "a valuable benefit of some kind, over and above the initial value" of

their payments to LGC. Amended Petition ¶ 110. Instead, payments made by risk pool participants *are* for a valuable benefit – risk coverage – and are *not* made with any expectation of receiving any benefit "over and above the initial value" contributed.

Even if the risk pool contracts somehow were deemed to be securities, LGC and the risk pool contracts would be exempt from the registration requirements the Bureau cites in Count III. RSA 421-B:17, I(a) exempts securities "issued or guaranteed" by "subdivision[s] of a state" or "other instrumentalit[ies]" of a state. The New Hampshire Supreme Court has found that LGC and its sub-entities are governmental entities. Therefore, LGC and its sub-entities are instrumentalities of the state and subject to the exemption at RSA 421-B:17.

COUNT IV (¶¶ 118-122)

Knowing or Negligent Aid in the Sale of Unregistered Securities by Unlicensed Broker-Dealers, Issuer-Dealers, and Agents by the Individual Respondents in Violation of RSA 421-B:26, III-a

The allegations of this Count are directed exclusively at Respondents other than LGC. Accordingly, no response to these allegations is required.

COUNT V (¶¶ 123-128)

Fraud, Deceit and Material Omissions in Connection with the Offer or Sale of Securities in Violation of RSA 421-B:3

Count V alleges that LGC has "failed to disclose material facts, in connection with the offer or sale of securities ...." Amended Petition ¶ 124. As explained, *supra,* in connection with Count III, LGC has not engaged in the sale of securities. LGC cannot be penalized for having "failed to disclose" that "NHMA membership contracts and 'risk pool contracts' are unregistered securities" (*id.* ¶ 125), or for not being licensed to sell securities (*id.*), when, in fact, the contracts are not securities.

COUNT VI (¶¶ 129-135)
Civil Conspiracy

The allegations of this Count are directed exclusively at Respondents other than LGC. Accordingly, no response to these allegations is required.

Affirmative and Other Defenses

LGC may raise any or all of the following affirmative and other defenses in this matter:

A. The Secretary lacks the authority to regulate any activities of any RSA 5-B risk pool prior to June 29, 2009, the effective date of the amendment of RSA 5-B:4.

B. The Secretary lacks the authority to impose penalties related to the activities of any RSA 5-B risk pool that occurred prior to June 14, 2010, the effective date of the enactment of RSA 5-B:4-a.

C. The Secretary's attempt to regulate LGC only, rather than the RSA 5-B pools as a group, is a selective prosecution, barred by the Bill of Rights and the Constitutions of the State of New Hampshire and the United States.

D. The Secretary's selective prosecution of LGC only, rather than the other RSA 5-B pools for which similar complaints have been received by the Secretary, is barred by the Bill of Rights and the Constitutions of the State of New Hampshire and the United States.

E. The selective prosecution of LGC only, rather than the other RSA 5-B pools for which the Bureau knows similar alleged violations exist, is barred by the Bill of Rights and the Constitutions of the State of New Hampshire and the United States.

F. The Secretary's lack of complaint concerning LGC's actions, plainly reported in LGC's annual corporate and RSA 5-B filings to the Secretary, constitutes a waiver of any claims on those topics.

G. The Secretary's lack of complaint concerning LGC's actions, reported in LGC's annual corporate and RSA 5-B filings, administratively estops the Secretary from making claims on those topics.

H. The Secretary's lack of complaint concerning LGC's actions, reported in LGC's annual corporate and RSA 5-B filings, constitutes laches, barring any claims on those topics.

I. The lack of rule-making on any of the topics described in the Amended Petition is a bar to any attempt to penalize LGC by administrative or judicial fiat.

J. The lack of rule-making on the regulatory standards being applied in the Amended Petition to claim a violation of RSA 5-B and RSA 421-B is a bar to any attempt to penalize LGC by administrative or judicial fiat.

K. The vagueness of the statutes (both RSA 5-B and RSA 421-B) bars any attempt to penalize LGC by administrative or judicial fiat.

L. Deference to the judgment of the Respondents is warranted, as the actions taken by LGC and its pools were taken pursuant to the best business judgment exercised by its Boards, at the time, given the available information, and with the advice of consultants and legal counsel, and were similar to those taken by other pools, both within and without New Hampshire.

M. The actions by LGC do not fall within the definitions of actions regulated by the Securities Act; if they fall within the definitions, the actions fall within an exemption granted under the Act.

N. The Bureau's fanciful construction of the risk pool Member Agreements as 'investment contracts' fails, because political subdivisions of New Hampshire are limited by statute to the type of investments in which they may legitimately invest, and such investment contracts are not permitted.

O. To the extent the Amended Petition contains allegations of fraud, they are insufficiently described in any meaningful detail.

P. All the Counts of the Amended Petition fail to state a cause of action.

LGC reserves the right to amend this list of Affirmative Defenses, supplementing it with additional defenses that may appear during the discovery in this matter, and removing those that prove to have no application to the case.

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

By Their Attorneys:
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Dated: March 23, 2012

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CERTIFICATE OF SERVICE

I certify that on the 23rd day of March, 2012, I forwarded copies of this pleading *via* e-mail to all counsel of record.

_____/s/ William C. Saturley_____