STATE OF NEW HAMPSHIRE
DEPARTMENT OF STATE
BUREAU OF SECURITIES REGULATION

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

RESPONDENTS' RESPONSE TO THE BUREAU'S TRIAL MEMORANDUM

From the outset of this proceeding, the Bureau overreached both as to who,[1] and what, it charged.[2] The Bureau's opening statement promised much, and its evidence delivered little.[3] Even such evidence as it put in was undermined. [4]

The Bureau resorts in its Trial Memorandum to the last refuge of the desperate: "if we say it often enough, the Presiding Officer may believe it." The Bureau repeats *ad nauseum* that RSA 5-B requires an "independent" board and bylaws – when no such word appears. The Bureau repeatedly argues that LGC subsidized its workers' compensation program because it was PRIMEX's strongest program -- the evidence, by contrast, demonstrates that LGC supported the program because it was part of a comprehensive, strategic plan which benefitted all members. The Bureau repeatedly claims "there is little doubt" that LGC's members viewed Participation Agreements as investment securities, and they had "a clear expectation of profit" when joining – but the only member representatives who testified said the direct opposite.

The Bureau failed to meet its burden, and this matter should be dismissed in its entirety.

[1] One of the named Respondents was deceased.

[2] The original Staff Petition charged that Respondent John Andrews was the "Member" of LGC HealthTrust, LLC, and therefore the owner of the millions of dollars in assets held by LGC HealthTrust for the benefit of its members.

[3] The Bureau claimed the evidence would demonstrate that LGC acted "intentionally, unethically and unscrupulously," when the evidence actually demonstrated that Respondents acted in good faith, prudently, and in the best interests of LGC's members, saving them millions of dollars.

[4] During its direct examination of Andrews, the Bureau chastised him for the practice of compensating board members to attend meetings, ostensibly in violation of RSA 5-B, I(b). The Bureau later stipulated that the law was not enacted until after Andrews' retirement in September 2009. The Bureau charged that LGC made multiple trips to the New Hampshire Supreme Court to fight disclosure under the Right-to-Know law, in bad faith. The 2004 opinion in which the Supreme Court found LGC's position was taken in good faith was later entered into evidence. A further opinion by the Court, upholding LGC's position on other Right-to-Know issues, was released while this hearing was underway. *P.F.F. v. N.H. Local Government Center*, -- N.H. – (Docket No. 2011-550, May 11, 2012).

I. COUNT I – CORPORATE GOVERNANCE

The Bureau's cursory discussion of Count I warrants only a brief reply: the word "independent" does not appear in RSA 5-B. Further, the only expert testimony on the issue came from Attorneys McCue and Samuels, who testified unequivocally that LGC is in compliance with the organizational requirements of the statute. Tr. at 1633-35, 1933-34.

In a convoluted discussion on page 7 of its memorandum, the Bureau argues that without reading the word "independent" into RSA 5-B, the result could be a board comprised of out-of-state elected officials. The *sine qua non* of a 5-B program is that it is member-driven and member-managed. A majority of LGC's directors are required to hail from the member organizations. Tr. 1613; RSA 5-B:5,I(b). Indeed, LGC's board is comprised solely of member representatives. Accordingly, the absence of the word "independent" would not create, and clearly has not led to, the Bureau's theoretical result.

The Bureau mischaracterizes the actual structure of LGC in order to gild its wilted lily. The Bureau asserts that LGC operates two pooled risk management programs. It does not. LGC is a pooled risk management program with lines of coverage housed in subsidiary, single member LLCs. Tr. 1633-35. The LLCs were created for the purpose of protecting the assets of one line of coverage from the liabilities of another line of coverage. Even if the Presiding Officer concludes that the subsidiary LLCs are separate risk pool programs, they each are governed by LGC's board and written by-laws. The statute requires nothing more.

The Bureau next argues that LGC's current corporate structure has "relieved the LGC Board from direct fiduciary duties to the LLC risk pools," and is "fraught with inherent conflicts of interest . . . ." In addition to (again) misstating what the statute actually requires, the Bureau fails to cite to a single witness or exhibit to support these assertions.

The Bureau appears to argue – for the first time – that the LGC has also violated rules pertaining to corporate structure by "converting the non-profit corporate entities that originally controlled the risk pools into LLCs managed by another entity." (Bureau's Trial Memorandum, "Memo", at 6). This argument is made without citation to any section of RSA 5-B requiring pooled risk management programs to be structured as non-profit entities, or any citation to supporting evidence, because neither exists. Once again, the Bureau failed to prove its claim.

II. COUNT II

A. Level of Reserve. The Bureau's argument turns on a misguided interpretation of the requirement that LGC "[r]eturn all…surplus in excess of…reserves." The interpretation disregards other provisions of the statute, and imposes requirements that do not exist.

First, the statute says nothing about an actuarially derived unique correct answer to the reserve calculation, but instead directs the actuary in general terms to "*assess the adequacy* of…the reserves necessary to be maintained to meet expenses…*and other projected needs* of the plan." RSA 5-B:5, I(f)(emphasis added). If actuaries were simply to perform a mechanical calculation to arrive at a single "required" conclusion, a list of factors so open-ended as to include "other projected needs" of the plan would be illogical.

Second, there is no evidence that it would even be possible for an actuary to arrive at a unique correct answer to the question. These are discretionary judgments on which reasonable people (including actuaries) may disagree. Notwithstanding the scientific-sounding veneer of the Bureau's observation that "Mr. Atkinson established that the actuarially appropriate level of net assets for LGC in 2010 was $41.4 million at a 95% confidence interval" Memo at 11, there was no evidence that any calculation established "*the* actuarially appropriate level of net assets"—as opposed to *an* actuarially appropriate level—or that the 95% confidence level is mandated by the statute. Indeed, the Bureau's current contention that an RBC of 2.1 is required is at odds with its Risk Pool Agreement with PRIMEX, in which the Bureau signed off on an RBC ratio of *3.0 or greater*. (LGC Ex. 334 §§ 3.1, 3.4; *see, also*, BSR Ex. 65 (SchoolCare Risk Pool Practices Agreement). If (as the Bureau claims) the statute *requires* an RBC of 2.0 or 2.1, how could the Bureau agree to let PRIMEX maintain an RBC ratio of 3.0 or greater, and allow the Board to determine the appropriate reserve level?

In an instructive concession, "the Bureau allows that *some amount* of net assets falls under the actuarial calculation of funds needed to absorb unexpected costs to satisfy the obligations of the pooled risk management program to its Members. The critical question here then is what amount of net assets is actuarially appropriate." Memo at 9. Absent a mathematical formula for fixing the "some amount" component of the reserve calculation, how could LGC's Board have done anything other than exercise its business judgment in making a decision?

Third, the notion that there is such a thing as "*the* actuarially appropriate level of net assets" that corresponds to an RBC ratio of 2.0 or 2.1 is flatly inconsistent with the clear statement by the National Association of Insurance Commissioners ("NAIC") that it is a "misconception" that an RBC ratio of 2.0 "is somehow a measure of 'adequate' capital," and "[t]here is no evidence that companies that are consistently operating at *or near* this surplus level are sound . . . ." (LGC Ex. 357). Accordingly, the level of reserves the Bureau claims LGC should have maintained *cannot* be presumed to be appropriate. *See, also*, RSA 404-F.[5]

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[5] The Bureau seeks to explain away evidence that an RBC ratio of 2.0 or 2.1 would leave LGC on the brink of insolvency (*see, e.g.*, Tr. 1295) with this piece of reassurance: in the 1-in-20 event that LGC were to have inadequate capital, the "greater likelihood" is that the shortfall would be "closer to a penny than to a larger amount." (Memo at 11, n. 13). Insolvency, however, is insolvency, and the Board's reasonable business judgment was that it would not run a 1-in-20 risk of insolvency (which would, if one does the math, likely have caused LGC to become insolvent at least once over the 20-plus years of its existence).

The Memorandum also pretends that LGC claims its Board has "<u>unlimited</u> discretion" Memo at 10 (emphasis in original) to set reserve levels, and that "the appropriate level of net assets rests *solely* in the discretion of the Board." (*Id*. at 9 (emphasis added)). By contrast, the LGC Board operates within the parameters established by RSA 5-B, New Hampshire's corporations statutes, the common law of fiduciary duties, and the business judgment rule. Within those parameters, the Board has *some* discretion to set a level of reserves based on the advice of its consultants and counsel; LGC has never claimed to have "unlimited" discretion. Again, the Bureau has expressly permitted this approach with other risk pools. (*See* LGC Ex. 334 §§ 3.1, 3.4; BSR Ex. 65).

B. Return of Surplus. Suffice it to say here that (1) it is the preference of LGC's members to have surplus returned in the form of rate credits (Tr. 1843, 2380-81); (2) nothing in the statute prohibits this method of return; and (3) if (as Bureau claims) return of surplus is purely a mechanical function of determining what is "actuarially required" and writing a check for the balance, why does RSA 5-B:5, I(g) direct risk pools to "conduct 2 public hearings…to solicit comments from members regarding the return of surplus…"? What would be the point of soliciting public comment on the method of returning surplus if it were a mechanical process where the Board had no discretion?

C. Unjust Enrichment. The Hearing Officer cannot order the remedy sought by the Bureau, because "[u]njust enrichment is an equitable remedy, found where an individual receives a benefit which would be *unconscionable* for him to retain." *Clapp v. Goffstown Sch. Dist.*, 159 N.H. 206, 210 (N.H. 2009)(emphasis added). Here, the LGC Board acted at all times on the advice of its consultants and counsel and in what it judged to be the best interests of its members. Indeed, the initial decision for HealthTrust to subsidize the workers' compensation program was approved by an independent HealthTrust board in 1999, based on what that board believed, in its business judgment, to be HealthTrust's best interests.[6] (*See* LGC Exs. 3, 7). Subsequent Boards agreed with this judgment. *See, e.g.*, LGC Exs. 62, 63, 67-8, 70, 425. As such, the unconscionability requirement for an unjust enrichment finding cannot be met.

D. Retroactivity. The Bureau asserts the Hearing Officer "may find any violations of the statute that occurred *or continued* on or after June 14, 2010." Memo at 3 (emphasis added). LGC agrees that the Hearing Officer has statutory authority to impose penalties for violations of the statute that may have *occurred* after June 14, 2010, and to impose penalties in connection with *that portion of any continuing conduct* that occurred after that date, but notes that the Hearing Officer cannot reach back *before* June 14, 2010, to sanction LGC for conduct that was not then subject to sanction. The Bureau cites no support (nor could it) for the proposition that such a gaping loophole exists in the New Hampshire Constitution's prohibition against retrospective laws (Part I, Article 23).

III. RESPONDENTS HAVE NOT VIOLATED OR FACILITATED VIOLATIONS OF THE MUNICIPAL BUDGET ACT

The Bureau ignored the testimony of Peter Loughlin on this topic, and provided no contradictory testimony:[7] New Hampshire's Municipal Budget laws do not apply to funds held by LGC or its risk pools. *See* Tr. 2017:4-2018:1, 2027:13-2030:6, 2037:6-11; Tr. 1070:2-1071:11; RSA 32:2, 34:1-a, 35:1-c.

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[6] Administrative expenses under RSA 5-B include the cost of "distributing risk", "risk management" and "loss prevention services." See RSA 5-B:2(IV) & 3(I). The governing board of a pooled risk management program is thus permitted to support a separate and distinct program or risk pool, if the Board believes it will be in the best interest of its program's members by, for example, reducing long term cost, preventing cost shifting to the program, or providing better risk management services to its members.

[7] The Bureau does not rely on the report of Mr. Coutu and ignores the testimony of Mr. Andrews when he confirmed that the return of surplus through "rate stabilization" "was a legal, permitted way." Tr. 542:7-14.

The Bureau's suggestion that LGC causes its members to violate the Municipal Budget Act should also be rejected. As Loughlin testified, nothing about the rate stabilization process facilitates any violations of the Municipal Budget Law. Tr. 2038:3-2039:4. Again, no legal or factual support was offered for the notion that the Municipal Budget Act requires an annual return of surplus as cash.

IV. RESPONDENTS ARE NOT LIABLE UNDER COUNTS III, IV, AND V

A. The Bureau Failed to Establish That Participation Agreements Are Securities. The Bureau fails to satisfy three of the four prongs used to determine "investment contracts." *See S.E.C. v. W.J. Howey Co.*, 328 U.S. 93 (1946). First, while "[p]urchasing insurance coverage is basically a financial proposition," that does not make it an "investment of money" under *Howey* any more than purchasing subsidized apartments. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975). Memo at 19.[8] Under the Bureau's misinterpretation, whenever a municipality enters into a "financial proposition," like purchasing a snow plow, it makes an "investment." [9]

As to *Howey's* third requirement—a reasonable expectation of "profit"—not a single municipal representative testified that they joined a risk pool expecting a "profit."

Instead, the Bureau argues that LGC's return of unused member premiums via dividends or rate credits demonstrates a "clear expectation of profits" in the form of "a financial benefit." Memo at 20. This theory ignores what the insurance industry, every court to consider the issue, the SEC, and each testifying securities or actuarial expert has recognized: an insurance

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[8] Contrary to the Bureau's allegation, members do not "purchase" participation agreements: they enter into them to acquire coverage and participate in the risk pool. As the Bureau concedes, LGC members join risk pools for "[p]urchasing insurance coverage," which defeats any argument that they join for investment purposes.

[9] That members "pay money in and get benefits out in the form of money on claims" is hardly evidence of investment intent. As the Bureau's expert, Attorney Gregory Fryer, concluded, it is further evidence that the primary purpose of joining a risk pool is risk management, not investment. See Bureau Ex. 68C, ¶ 8.

provider's distribution of surplus is nothing more than the return of unused member premiums. *See Dryden v. Sun Life Assurance Co.*, 737 F. Supp. 1058, 1062 (S.D. Ind. 1989); *Collins v. Baylor*, 302 F. Supp. 408, 411 (N.D. Ill. 1969); *see also* Tr. 767:8-15 (Atkinson); Tr. 2103:8-13 (Murphy). Receipt of a "financial benefit" does not indicate an "expectation of profit."[10]

The Bureau saves its most novel arguments for *Howey's* final criterion, asserting that "the sheer volume of expert testimony and testimony regarding reliance on experts and consultants demonstrates that LGC is a complicated organization making highly complex decisions," and therefore its management is solely responsible for generating "profits", Memo at 21, the same management the Bureau derides in Counts I and II.[11] While the Bureau asserts, without explanation, that it is "absurd to suggest" that members can influence their claims experience, *id.* at 21, they do not explain how LGC can control the health of 77,000 insureds, the variable which ultimately determines whether HealthTrust generates excess surplus.[12] Tr. 1199:9-19, 1270:14-16, 1392:18-21; *see also* Bureau Ex. 68E at 102 (showing that health claims accounted for 93% of HealthTrust's total operating expenses in 2010).

The Bureau premises its purported satisfaction of *Howey's* last element on its demonstrably incorrect belief that LGC returns unused member premiums on a pro rata basis, despite uncontroverted evidence that a member's claims, not its contributions, determine its

[10] The Bureau cites testimony by Fryer and Samuels to support its claim that members expect profit. Like many in the Bureau's post-hearing memo, these citations are inaccurate and misleading. Fryer describes the third *Howey* prong as a "close call," Tr. 924:1, while Samuels testifies that *theoretically* a rate credit could meet it, he "suppose[s]." Tr. 1995:6-14. Respondents urge the Presiding Officer to carefully examine each of the Bureau's citations to the record.

[11] The Bureau continues its undue emphasis on the investment of Member funds, a practice common to all insurers. By its expert's calculations, HealthTrust's investment income accounted for 0.45% to 0.96% of its annual revenue from 2002 to 2010. *See* Bureau Exs. 5-7. The Bureau also continues to argue that the 2007 Bylaw amendments allowing for surplus return through rate credits "further emphasized the investment nature of the Participation Agreements." Memo at 23. They do not explain why this is true, nor have they cited to a decision supporting this theory.

[12] The Bureau ignores evidence clearly establishing that workforce training and education allows members to alter risky behavior and make healthier life style decisions leading "to better medical outcomes and lower health care costs." Tr. 2212:7-2213:18. While they now claim such testimony is absurd, they did not challenge it at the Hearing.

share of surplus. Extensive testimony and specific documents showed how claims experience dictates member returns. *See* Tr. 1413:9-15 (Parker); Tr. 1507:13-20 (Keefe); Tr. 2103:14-19, 2107:18-2108:6 (Murphy); *see also* LGC Ex. 166 at 28 (explaining how PLT *presently* calculates dividends).

B. The Bureau Failed to Show that Respondents Acted Negligently. The Bureau claims that "Respondents' failed to demonstrate that classifying Participation Agreements as securities was ridiculous or beyond reasonable expectations." Memo at 22. Respondents have no such burden. Rather, the Bureau must show negligent acts by Respondents, an impossibility given:

- Dozens of S.E.C. no-action letters dealing with substantially similar facts;
- Testimony from two experienced securities practitioners that they never would have considered the security status of participation agreements;
- The Bureau allowing the state's other risk pool operators to avoid complying with RSA 421-B;
- Respondents' reliance upon the advice of counsel; and
- The Bureau's failure to declare that participation agreements constitute investment contracts until one month before filing their original Petition, twenty months after they received the alleged "security," two-plus years after beginning their investigation of LGC, and twenty-five years after the Legislature passed RSA 5-B.[13]

Finally, the Bureau continues to vacillate on which provisions of RSA 421-B Respondents allegedly violated. The Bureau originally charged Respondents with acts of fraud and deceit under RSA 421-B:3, I(c), Am. Pet. ¶ 127, charges the Bureau now suggests should have been charged under RSA 421-B:3, I(b) as failures to disclose. See Memo at 24; Tr. 1737:9-10. The Bureau concludes their post-hearing brief with a suggestion that Respondents violated

[13] Despite this evidence, the Bureau argues that Respondents were obligated to seek a no-action letter regarding the security status of its participation agreements, an allegation wholly absent from its Amended Petition.

yet another provision, RSA 421-B:3, II(c). Memo at n. 37. Nothing better illustrates the weakness of the Bureau's case than a footnote at the end of its post-hearing brief declaring, after investigation and trial, that Respondents violated additional, previously unmentioned provisions.

Dated June 7, 2012

Respectfully submitted,

LOCAL GOVERNMENT CENTER, INC., et al.

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CERTIFICATE OF SERVICE

I hereby certify that I have, this 7th day of June 2012, filed two printed copies with the Office of the Secretary of State, and forwarded copies of this pleading *via* e-mail to all counsel of record.

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