Memorandum

TO: MAO

FROM: SPJ

DATE: March 11, 2014

RE: *Kentucky Department of Insurance v. Kentucky School Board Insurance Trust Property and Liability Fund, et al.*
Franklin Circuit Court, Civil Action 13-CI-CI-1282, 13CI-1296, and 13-CI-1297 Consolidated
Summary of Deposition of Doug Goforth (Day 2) and Deposition of Dawn Harlow

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The second day of the deposition of Doug Goforth took place on February 13, 2014 and Dawn Harlow's deposition occurred on February 14, 2014. At the start of each deposition, I reserved the right to depose Goforth and Harlow regarding the breach of fiduciary duty and mismanagement issues raised in the intervening complaint at a later date.

Deposition of Doug Goforth

At Goforth's first deposition, I reserved our right to question him because we had not yet had a chance to review the nearly 4,000 pages that KLC produced in response to discovery requests. This second deposition was scheduled after our review of all the documents. I requested on the record that counsel for KLC provide a privilege log explaining the redactions made in the documents produced in response to the DOI's discovery requests.

Kentucky League of Cities Insurance Agency ("KLCIA") is a wholly-owned subsidiary of KLC whose primary purpose is to market the programs of KLCIS. KLCIA oversaw the network of local agents that marketed the KSBIT program pursuant to a contract between KSBIT and KLCIA. The fee paid to KLCIA is reflected on the KSBIT Quarterly Statements in the agent commission line item.

When KLC was considering the deal with KSBIT in 2009, Goforth remembers conversations among KLC employees that an assessment of KSBIT's members could reflect negatively on all self-insurance risk pools. Goforth could not recall if KLC kept track of the time its employees spent on bringing about the KSBIT deal, tried to recoup this money from KSBIT or KSBA or tried to recoup other marketing expenses incurred prior to execution of the Master Agreement.

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KSBIT's and KLC's yearly independent audits contained footnotes regarding the $8 million Surplus Notes, which generally stated that KSBIT is responsible for repayment of the funds. E-mails between Goforth and the auditors show that Goforth provided this language for the Surplus Notes footnotes. Goforth admitted that he was extensively involved in drafting the footnotes; he either drafted or specifically approved of the language contained in the audits.

Deposition of Dawn Harlow

Dawn Harlow has been employed at KLC since April 2012. Before then, she worked as a Deputy Rehabilitator overseeing the rehabilitation and liquidation of an insurance agency with which she previously was employed. After her role as Deputy Rehabilitator concluded, she became a financial examiner on contract with the Department of Insurance. She was not a direct employee of the DOI but an independent contractor. Her first contract with the DOI was in 2003. Her responsibilities included assessing the risks of insurance organizations, evaluating their solvency and reviewing their financial statements. She reported to David Hurt, Chief Financial Examiner and Jeff Gaither, Deputy Financial Examiner.

Harlow examined KSBIT's financial condition as of 2006 and found that the funds were operating in a deficit situation. One of her main concerns was that the rates issued by KSBIT were inadequate to pay for all of the claims and losses the funds experienced. The adequacy of KSBIT's reserves was evaluated by an outside actuary Taylor Walker. There were also concerns of inadequate cash flow and that KSBIT did not have the investment income sufficient to allow KSBIT's discounting practices for the Workers' Compensation ("WC") Fund. Moreover, KSBIT historically recorded their reserves at the lower end of the actuarial range when best practice is to use the middle of the actuarial range.

At the time of Harlow's examination, there was discussion of an assessment to resolve KSBIT's deficit position. Anytime a fund reports a deficit it is required by statute to file a corrective action plan ("CAP") to remedy the deficit and to submit an assessment plan. KSBIT's WC Fund had been operating under a CAP for many years which outlined items for KSBIT to undertake to try to cure the deficit without assessing its members.

Harlow also conducted a target examination of KSBIT's financial condition as of June 30, 2008 at the direction of Commissioner Clark to reevaluate the state of the deficit. Her major findings were that the rates and premiums charged were inadequate to cover KSBIT's losses, the deficit was growing and an assessment should be ordered. KSBIT set rates contrary to what they were directed to do in their CAP (they were "heavily discounting" the rate).

If the deficit was not cured by the end of 2009, the Commissioner was going to order an assessment. KSBIT was worried that an assessment would cause them to lose their membership and they would no longer have a viable risk pool. To avoid assessment, KSBIT first approached KACO and then tried to organize a deal with Ross, Sinclaire & Associates to infuse capital into KSBIT to satisfy the deficit. After those discussions fell through, KSBIT and KLC entered into negotiations. At this time, Harlow was performing a financial examination of KLCIS.

E-mail correspondence in 2009 between Harlow and other DOI contractors discussed how the Surplus Notes should be accounted for on financial statements. Both KSBIT and KLC reported their financial statements on a GAAP basis but surplus notes are not allowable under GAAP. Ultimately, both KSBIT and the KLC Workers' Compensation Fund recorded the $8 million as an asset.

The deal with KLC was intended to cure KSBIT's reported deficit based on the low end of the actuarial range which spanned $8 million to $14-16 million. If the $8 million were provided to KSBIT via a promisory note it would not serve the purpose of eliminating KSBIT's recorded deficit because it would be accompanied by an unconditional duty to repay those funds.

Harlow testified that the Commissioner stated that the $8 million would be repaid to KLC in the event of an assessment. The Commissioner made this statement at an unspecified meeting between the DOI, KSBIT and KLC, which occurred sometime in 2009. According to Harlow, it was always the understanding of DOI employees that the notes were to be included as part of an assessment, and she included this understanding in the examination report of KLC's financial condition, which she prepared as a contractor financial examiner.

Harlow also admitted that she, with advice from legal counsel, was directly responsible for drafting the audit footnotes regarding the Surplus Notes. Since 2012, the footnotes have changed to "clarify" that the notes would be repaid upon assessment of the KSBIT members.

Harlow testified that in 2009, a state audit of KLC uncovered inappropriate expenditure of funds by KLC's top executives (Sylvia Lovely, Neil Hackworth, and Bill Hamilton). There was speculation that Bill Hamilton left KLC due to the audit findings.