California Physicians’ Service, dba Blue Shield of California, (“CPS”), a health care service plan licensed under the Knox-Keene Health Care Service Plan Act of 1975, as amended (the “Knox-Keene Act”), submits this Notice of Material Modification (the “CPS Notice”) to the California Department of Managed Health Care (the “Department”) to provide information regarding a proposed transfer of capital assets to be used in the acquisition of Care 1st Health Plan (“Care 1st”), a health care service plan licensed under the Knox-Keene Health Care Service Plan Act of 1975, the impact of such transaction on CPS and the administrative services agreement between CPS and its affiliates that will follow.

II. Summary

The proposed change of control (the “Proposed Transaction”) will result from the sale of all of the outstanding capital stock of Care 1st pursuant to the Stock Purchase Agreement, dated December 4, 2014 (the “Stock Purchase Agreement”), by and among Care 1st; the shareholders of Care 1st (the “Shareholders”); CPS, Cumulus Holding Company, Inc. (“Cumulus”); and CFHP Seller Representative LLC (“Seller Representative”) (collectively sometimes referred to herein as the “Parties”).

The sole source of funding for the Proposed Transaction will be a grant and transfer of $1.25 billion from CPS to Cumulus. Upon the closing of the Proposed Transaction (the “Closing”), and pursuant to the terms of the Stock Purchase Agreement, Cumulus will acquire all of the outstanding capital stock of Care 1st, making Care 1st a subsidiary of Cumulus and an affiliate of CPS. Immediately following the Closing, Care 1st, currently a California for-profit corporation, will be converted to a California non-member nonprofit mutual benefit corporation to be effected by an amendment and restatement of the Articles of Incorporation of Care 1st pursuant to Section 911 of the California Corporations Code. Also immediately following the Closing, CPS, Cumulus and Care 1st will enter a mutual administrative and support services agreement (“Intercompany ASA”) whereby each affiliate will be able to provide and receive administrative services to and from each other.

After the Department has considered the information set forth in the CPS Notice, CPS respectfully requests that the Department issue an order approving the CPS Notice and the Proposed Transaction.

The CPS Notice is being filed concurrently with a Notice of Material Modification by Care 1st
addressing the impact of the Proposed Transaction upon Care 1st (the “Care 1st Notice”) and a Notice of Material Modification by Care 1st Health Plan Partner (QIF), which simply cross references the Care 1st Notice. A copy of the Stock Purchase Agreement (both public and redacted versions), is attached as Attachment 1 to Exhibit E-1 in the Care 1st Notice and is not duplicated in the CPS Notice.

A. Overview of the Parties

1. Care 1st.

Care 1st is a California corporation and a Knox-Keene licensed health care service plan with operations in and throughout California and in El Paso County, Texas. Care 1st also has four direct or indirect subsidiaries: Care 1st Health Plan Partner (QIF), which currently holds a contract with the California Department of Health Care Services for Medi-Cal managed care services in San Diego County; Care 1st Health Plan of Arizona, Inc. which operates Medicaid plans in Arizona; Care 1st Administrative Services, Inc. an administrator licensed by the Arizona Department of Insurance, and Onecare by Care 1st Health Plan of Arizona, Inc. which operates a Medicare Advantage plan in Arizona.

As of September 30, 2014, Care 1st had a total membership, as reported on the DMHC financial report, of 509,308 members, including 42,695 Medicare Advantage members, 299,654 Medi-Cal Risk members, and 166,954 members contracted from other plans under plan-to-plan agreements. As of the date of this CPS Notice, Care 1st is current with its regulatory filings with the Department.

2. Seller Representative.

Seller Representative is a California limited liability company established to represent the interests and to act on behalf of the Care 1st shareholders following the Closing of the Proposed Transaction.

3. CPS.

CPS is a non-member, nonprofit California mutual benefit corporation and Knox-Keene licensed health care service plan with significant operations throughout California. As of September 30, 2014, CPS had a total membership, as reported on the DMHC financial report, of 3,189,946 members, including 835,107 Large Group Commercial members, 93,475 Medicare Advantage members, 134,185 Medicare Supplement members, 84 Individual (HMO) members, 63,424 Point of Service Large Group member, 82,340 Small Group Commercial members, 806,872 ASO members, 536,365 PPO Individual members, 69,846 PPO Small Group members, and 568,248 PPO Large Group members. As of the date of the CPS Notice, CPS is current with its regulatory filings with the Department.
4. **Cumulus.**

Cumulus is a non-member, nonprofit California mutual benefit corporation. Cumulus was incorporated in connection with the Transaction as an affiliate of CPS that will act as a holding company for Care 1st.

Cumulus was incorporated on December 1, 2014, and its Articles of Incorporation establish a corporate purpose similar to that of CPS. Further, Cumulus’ Bylaws provide that all of the members of the Cumulus board of directors are to be designated by CPS and its current officers are senior officers of CPS and, accordingly, the two corporations are under common control and “affiliates” pursuant to California Corporation Code section 5031, as well as California Code of Regulations, title 28, §1300.45(c). Following the Proposed Transaction, the CPS/Cumulus board of directors will be appointed as the board of directors for Care 1st with the intent to advance the common corporate purpose of each of CPS, Cumulus and Care 1st.

B. **Ownership After the Proposed Transaction**

After the Closing, Care 1st will be converted from a for-profit California corporation to a non-member, nonprofit California mutual benefit corporation. Care 1st’s Bylaws will be amended and restated to be virtually identical to those of Cumulus except that Cumulus, rather than CPS, shall designate all of the members of the board of directors of Care 1st, which are intended to be identical to the members of the Board of Cumulus, and accordingly, the two corporations are under common control and “affiliates” pursuant to California Corporation Code section 5031, as well as California Code of Regulations, title 28, §1300.45(c).

Diagrams of CPS’ pre- and post-Closing affiliate organizational structures reflecting the addition of Cumulus and Care 1st are attached under Exhibit L, and narrative descriptions of the diagrams are attached under Exhibit M-1.

C. **The Proposed Transaction furthers CPS’ mission of serving all Californians**

CPS has been considering its options to expand in the California market. Although CPS is a statewide plan with commercial HMO, PPO, and EPO products and participates in the Medicare Advantage program, CPS does not currently participate in the Medi-Cal program. CPS has been contemplating entering the Medi-Cal program for some time in order to further its mission of serving all Californians. After much deliberation, CPS has concluded that acquiring Care 1st is the most efficient way for it to move into Medi-Cal managed care.

Currently, Care 1st has almost 299,654 Medi-Cal enrollees based on a direct contract with the California Department of Health Care Services (DHCS) covering San Diego County and a subcontract with LA Care for Los Angeles County.

With the acquisition of Care 1st through Cumulus, CPS, through its affiliates, becomes one of the largest Medi-Cal managed care plans in California.
III. Knox-Keene Act Considerations

A. CPS Reserve Requirements

As part of this transaction, CPS will make a grant of $1.25 billion to Cumulus, which will use the proceeds to purchase the outstanding stock of Care 1st. As discussed below, CPS’ ability to comply with the reserve requirements found in Rule 1300.76 will not be impacted in a material way by the capital transfer.

1. Current TNE Position

As indicated in financial statements submitted to the Department, as of the quarter ended September 30, 2014, CPS has a total net worth of $4,348,172,000 and tangible net equity (TNE) of $4,149,464,000, with required TNE of $286,552,000 and excess TNE of $3,862,912,000. For the same quarter, CPS had revenue of $2,994,366,000; total expenses of $2,970,163,000, including $2,539,798,000 of medical and hospital expenses and $430,365,000 of administrative expenses; and suffered a net loss of ($14,245,000).

2. Post Transaction TNE Position

The $1.25 billion grant to Cumulus does not represent a significant reduction in capital for TNE compliance purposes because of the significant surplus currently maintained. CPS currently has 1,448% of its minimum required TNE. Using quarter ended September 30, 2014 financial statements, a deduction of $1.25 billion in TNE would still leave CPS with TNE of $2,899,464,000 and excess TNE of $2,612,912,000. CPS will still have 1,012% of its minimum required TNE, which is still well above many of its competitors including Anthem Blue Cross (476% of its minimum TNE) and Health Net (535% of its minimum TNE) based on financial statements submitted to the Department for quarter ended September 30, 2014.

CPS is a well-capitalized, diversified, health care company with strong market position and substantial excess tangible net equity. Even post transition, CPS will remain a financially strong health plan.

As requested by the Department, CPS is filing the following information to demonstrate continued financial viability of CPS:

(i) Under Exhibit HH-32-1, revised income and expense projections for CPS on a monthly basis for the first year following closing and on a quarterly basis for the second year following closing; balance sheet projections with pre and post-closing snapshots, cash flow projections and TNE projections including pre and post-closing calculations;
(ii) Under Exhibit HH-32-2, projected income and expense statements for Cumulus, projected balance sheets with pre and post-closing snapshots, and projected cash flow statements;

(iii) Under Exhibit HH-32-3, a copy of the Houlihan Lokey fairness opinion and an explanation of the methodology used by CPS for determining the purchase price.

B. The capital transfer to Cumulus is not a Restructure under 1399.71

Health and Safety Code section 1399.71 places certain requirements on a plan that restructures itself from a nonprofit health plan to a for-profit health plan. However, section 1399.71 does not apply to this transaction.

Health and Safety Code section 1399.71 is found in Article 11 of the Knox-Keene Act. The application of Article 11 is governed by Health and Safety Code section 1399.75, which states in part:

(a) This article shall apply to the restructuring or conversion of nonprofit mutual benefit health care service plans to the extent these plans have held or currently hold assets subject to a charitable trust obligation, as determined by the director.

Since CPS does not currently hold and has not previously held assets subject to a charitable trust obligation, Article 11, including section 1399.71, does not apply to CPS. Moreover, CPS is not converting or restructuring its activities, it is simply making a grant and transferring funds to Cumulus. (A transfer of assets is not defined as a “restructure” under section 1399.75(b) as it is under the broad definition applicable to section 1399.71).

C. Accounting Treatment of Transaction and Presentation of Financial Statements

CPS’s grant to Cumulus will be recorded as a non-tax deductible expense on CPS’ income statement. The goodwill and intangible assets created in connection with the Proposed Transaction will reside on Cumulus’ balance sheet in accordance with GAAP. Following the Closing, Care 1st and CPS will continue to file separate financial reports with the Department.

D. Intercompany Administrative Services Agreement

CPS, Cumulus, Care 1st and their respective affiliates will be providing and receiving administrative and support services to and from each other. In connection with the Proposed Transaction, and effective as of the Closing, CPS, Cumulus and Care1st will enter into the Intercompany ASA attached hereto as Exhibit N-1. Pursuant to the Intercompany ASA, CPS, Cumulus and Care 1st will provide and receive personnel, administrative, operational, and other services and support as needed to and from each other. The administrative arrangements for monitoring of the Intercompany ASA by CPS are attached under Exhibit N-2 to this Notice.
E. Authorization

The parties to the Proposed Transaction have obtained the required shareholder and board approvals to consummate the Proposed Transaction.

F. Regulatory Approvals

The Proposed Transaction is conditioned upon the receipt of the Department’s approval of the Care 1st and the CPS Notices. As sought by this CPS Notice, CPS is requesting approval by the Department as is Care 1st with the Care 1st Notice. Additionally, Care 1st is seeking the approval of the Arizona Health Care Cost Containment Services and the Arizona Department of Economic Security. CPS and Care 1st are also seeking approval from LA Care. The United States Federal Trade Commission has reviewed the transaction from an antitrust perspective and, on January 16, 2015, granted early termination of the waiting period, meaning no further federal antitrust review is required and the transaction may proceed.

G. Target Closing Date

CPS respectfully requests review of this CPS Notice such that the Department may issue an order approving this Notice on or before April 30, 2015. CPS will cooperate fully and make itself available to answer any questions arising from the Department’s review.

H. No Other Knox-Keene Considerations

Other than the grant and transfer of $1.25 billion to Cumulus, the only other changes to CPS are reflected in the revised organization charts as well as the Intercompany ASA between CPS and its affiliates that are included in this filing. CPS is not making any other changes to its operations in connection with the Proposed Transaction.

IV. EXHIBITS TO FILING

E-1 Narrative Description of Filing (Public)
E-1 Narrative Description of Filing (Confidential)
L-1 Organization Charts
M-1 Narrative Information
N-1 Intercompany ASA
N-2 Oversight of Intercompany ASA
HH-32-1 Financial Projections CPS (Confidential)
HH-32-2 Financial Projections Cumulus (Confidential)
HH-32-3 Narrative explanation and Houlihan Lokey fairness opinion (Confidential)
RFCT Request for Confidential Treatment