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Dear Gabriel:

It was good talking with you the other day. This letter is in response to your request for further information regarding Blue Shield's proposed acquisition of Care1st Health Plan ("Care1st") (which I will refer to in this letter as the "proposed transaction"), and the applicability of Article 11 of the Knox-Keene Act to the proposed transaction.

Article 11 (Health & Safety Code sections 1399.70 – 1399.76) authorizes DMHC to take certain actions when a nonprofit plan holding assets subject to a charitable trust obligation seeks to restructure or convert itself into a for-profit plan. See Health & Safety Code section 1399.75(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.").

In a nutshell, Article 11 has no applicability to the proposed transaction. It was enacted to ensure that assets held in charitable trust by nonprofit health plans would continue to serve their charitable purposes in the event that the plan converts or restructures to become a for-profit plan. That is not what is happening here. Blue Shield is a nonprofit mutual benefit corporation that holds no assets subject to a charitable trust obligation, and that does not seek to restructure or convert itself to for-profit status. Instead, just the opposite: the proposed transaction seeks to convert Care1st, a for-profit health plan, into a nonprofit one, for the benefit of Californians and in a manner fully consistent with Blue Shield's mission and purpose. Below, I address when Article 11 is implicated, and why it does not apply here.

Blue Shield Holds No Assets Subject to a Charitable Trust Obligation

As a threshold requirement, Article 11 requires a plan that is restructuring or converting to hold or have held assets subject to a charitable trust obligation.

Blue Shield does not currently hold, nor has it ever previously held, assets subject to a charitable trust obligation. At the outset, therefore, Article 11 is simply inapplicable to Blue Shield.

Blue Shield is a California nonprofit mutual benefit corporation (a “mutual benefit”), organized pursuant to the California Nonprofit Mutual Benefit Corporation Law (Cal. Corp. Code §7110 *et seq.*). Corporations whose assets are dedicated to charitable purposes are formed under the Nonprofit Public Benefit Corporation Law (Cal. Corp. Code § 5110 *et seq.*) – a separate and distinct part of the California Nonprofit Corporation Law.

At the outset, it is critical to recognize the fundamental difference between charitable nonprofit (public benefit) corporations and non-charitable nonprofit (mutual benefit) corporations. With respect to the former, California law expressly requires that they be “not organized for the private gain of any person” and be “organized for public or charitable purposes.” (Cal. Corp. Code §5130). In contrast, mutual benefit corporations—like Blue Shield—may be organized “to engage in any lawful act or activity, other than credit union business, for which a corporation may be organized under such law.” (Cal. Corp. Code §7130). Moreover, upon dissolution, mutual benefit corporations may make distributions of gains, profits or dividends to any member (Cal. Corp. Code §7141), while such distributions are barred as “private gain” and expressly prohibited under the Nonprofit Public Benefit Corporation Law (Cal. Corp. Code §5410).

A review of Blue Shield's Articles of Incorporation and Bylaws makes it absolutely clear that it is organized solely under the Nonprofit Mutual Benefit Corporation law and not for any charitable purpose. Its governing documents are unambiguous and explicit in this regard. Neither Blue Shield's Articles of Incorporation or Bylaws—including past versions of such dating back to the incorporation of Blue Shield in 1939—have ever contained a charitable dedication clause or have otherwise established assets as being subject to any charitable trust obligation.

The creation of separate and distinct parts of the California Nonprofit Corporation Law for public benefit and mutual benefit corporations makes clear the basic point that not every nonprofit corporation is a charity. Mutual benefits are typically created for the benefit of the corporation's members. Examples of some large mutual benefits include the Academy of Motion Picture Arts and Sciences, the California Dental Association, the California Teachers Association, and the Olympic Club. Many homeowners' associations are mutual benefits.

Some mutual benefits are exempt from federal or state income tax, and some are not. Because mutual benefits are not charities, those that are tax-exempt qualify for exemption for other reasons. For example, the Academy of Motion Picture Arts and Sciences is exempt from federal income tax because it is a

“business league,” as described in section 501(c)(6) of the Internal Revenue Code, and the Olympic Club is exempt because it is a “social club” as described in section 501(c)(7) of the Internal Revenue Code.

As these examples demonstrate, nonprofit corporations come in many forms. Some are charities and others are not. Some are taxpayers and others are not. Yet, they are all nonprofit corporations. Blue Shield is a nonprofit corporation that is not a charity, is not a public benefit corporation, and is a full federal taxpayer that has been exempt from state franchise tax as a “social welfare organization” described in section 23701f of the California Revenue and Taxation Code. In fact, under California law, Blue Shield could not hold all of its assets in charitable trust because, if it did, it could not have incorporated or lawfully maintained its existence under section 7111 of the Nonprofit Mutual Benefit Corporation Law. As noted in section 7111 of that Law:

“...a corporation all of the assets of which are irrevocably dedicated to charitable, religious, or public purposes...may not be formed under this part.” (emphasis added).

Because Blue Shield is *not* a nonprofit public benefit corporation whose assets would be dedicated to charity, and because Blue Shield does not hold and has not held any assets subject to a charitable trust obligation as a nonprofit mutual benefit corporation, Article 11 simply does not apply to Blue Shield or to the proposed transaction.

The Proposed Transaction Is Not a “Restructuring”

Article 11 also requires the transaction to involve a restructuring of the nonprofit plan. The proposed transaction is not a restructuring. Health & Safety Code section 1399.71(d)(1) states:

a “restructuring” or “restructure” by a nonprofit health care service plan means the sale, lease, conveyance, exchange, transfer, or other similar disposition of a substantial amount of a nonprofit health care service plan’s assets, as determined by the director, to a business or entity carried on for profit. Nothing in this section shall be construed to prohibit the director from consolidating actions taken by a plan for the purpose of treating the consolidated actions as a restructuring or restructure of the plan.

Thus, to constitute a restructuring, the transaction would have to involve (1) a disposition of assets (2) to a for-profit entity, because Article 11 concerns efforts by nonprofits to convert to for-profit entities. In other words, a restructuring occurs where a substantial amount of the assets and business of the nonprofit plan are transferred to the for-profit entity, which continues the same business,

using the same assets and employees, the same customers, and same brand name. (See, e.g., Blue Cross of California and Health Net). That is not what is taking place here.

First, the proposed transaction does not involve the “sale, lease, conveyance, exchange, transfer, or other similar disposition” of Blue Shield’s assets. Rather, it involves Blue Shield’s acquisition (not the disposition) of an asset—namely, the Care1st entity.

Second, the transaction does not involve the disposition or conversion of any Blue Shield asset “to a business or entity carried on for profit.” After the closing, Care1st will be converted to a nonprofit California mutual benefit corporation—a corporation with the same structure and mission as Blue Shield and the holding company used to carry out the proposed transaction.¹ Care1st’s Bylaws will be amended and restated to be virtually identical to those of Blue Shield and the holding company and will ensure that the corporations are under common control and will constitute “affiliates.” After these transactions have been completed, Care1st will be a nonprofit with the same mutual benefit mission as Blue Shield.²

At a fundamental level, the conversion statute examines whether a transaction changes the basic nature of the nonprofit health plan into a for-profit entity. That the purchase involves money being paid to stakeholders in a for-profit entity does not meet the statutory definition of a restructure any more than a nonprofit plan’s purchase of a major software system from a for-profit vendor or payment for the construction of new facilities. The statute contemplates that a restructuring could occur in the context of a nonprofit that transforms itself by

¹ Under the proposed transaction, Blue Shield formed a nonprofit holding company, which, as a wholly-owned subsidiary of Blue Shield, will purchase the Care1st stock from Care1st’s shareholders. The holding company was formed to maintain separation between Blue Shield’s and Care1st’s lines of business and geographies and its Bylaws will ensure that Blue Shield and the holding company will be under common control and will constitute “affiliates” pursuant to Corporations Code section 5031, as well as California Code of Regulations, title 28, section 1300.45(c). This holding company will have the same nonprofit mutual benefit mission as Blue Shield and Care1st.

² As stated in its Bylaws (and similarly stated in its Articles of Incorporation), Blue Shield’s mission is to “enable the people of the State of California to obtain prompt and adequate health care services whenever needed on a periodic budgeting basis without injury to the standards of medical service, without disruption of the proper physician-patient relation and without profit to any agency, assuring that all payments made by patients except administrative costs will be utilized for health care services and not otherwise, in an efficient, coordinated and organized service which can, upon the same fundamental basis, be the means which governmental agencies -- federal, state, and local -- may use to provide, at the lowest possible cost to the taxpayer, good health care services.”

selling or otherwise conveying itself or a substantial portion of its assets to a for-profit, not a transaction that involves the acquisition of assets that will be organized and operated as a nonprofit with a mission identical to Blue Shield's.

The Proposed Transaction Is Not a "Conversion"

The proposed transaction also does not amount to a conversion as contemplated by Health & Safety Code section 1399.72(b). Per this section, "a 'conversion' by a nonprofit health care service plan means the transformation of the plan from nonprofit to for-profit status, as determined by the director." As noted, Blue Shield is not being converted via the proposed transaction to a for-profit entity. Just the opposite: the only conversion taking place via the proposed transaction is the conversion of Care1st from for-profit to nonprofit status, the reverse of the situation envisioned by section 1399.72(b).

Applying any of the sections under Article 11 to a situation that is the exact opposite of that which the law contemplated would stand the statute on its head. An examination of the remainder of section 1399.72(b) illustrates why Article 11 makes no sense in the context of the proposed transaction. Much of that section deals with conversion investigations and set-asides that are to occur when a nonprofit plan becomes for-profit. As noted above, the proposed transaction involves no charitable assets to "set aside" and the only assets that are undergoing a change in status belong to Care1st. It would contravene public policy to attempt to "set aside" any of Care1st's assets to serve a for-profit purpose as the plan itself converts to nonprofit status. In the alternative, to hold the proposed transaction as a conversion under Article 11 and force Care1st to set aside any of its for-profit assets for charitable purposes would be without any statutory or public policy support and would appear to amount to a taking under the Takings Clause of the Constitution. As one can see, it makes little sense to apply Article 11 to the situation here.

The Proposed Transaction Is in the Public Interest and Fully Consistent With Blue Shield's Purpose and Mission

I also want to emphasize that, in addition to the fact that Article 11 does not apply on its face to the proposed transaction, this transaction is in the public interest and poses none of the risks or concerns that Article 11 otherwise would address in transactions subject to its scope.

First, the use of only nonprofit mutual benefit corporations with missions identical to that of Blue Shield to carry out the proposed transaction guarantees that there is no potential for private inurement. As discussed, Care1st will be converted from a for-profit California corporation to a nonprofit California mutual benefit corporation—a corporation with the same structure and mission as Blue Shield and the holding company. At no point will any of the funds used

for the purchase be transferred to Blue Shield officers or directors—whether in the form of bonus payments tied to the transaction or in the form of stock or options (which are not possible because nonprofit mutual benefit corporations cannot issue stock). No officer or director of Blue Shield has any financial interest in the proposed transaction, and thus there is no concern of conflict of interest or inurement.

Second, the proposed transaction is fully consistent with Blue Shield's mission and purpose. As Medi-Cal continues to grow in scale and importance within the California health plan space, Blue Shield has long contemplated entering the Medi-Cal program to further its mission of serving all Californians. Care1st is an efficient and appropriate means for Blue Shield to enter the Medi-Cal managed space. After the proposed transaction is complete, Care1st will be dedicated—as Blue Shield is—to enabling the people of the State of California to obtain prompt and adequate health care services in the manner described in Blue Shield's governing documents. This mission will be applied immediately to Care1st's existing membership of over 500,000 and will be applied moving forward to all Californians enrolling in Care1st.

Neither Blue Shield's nor Care1st's operations will be negatively impacted by the proposed transaction. Care1st is well run and has extensive Medi-Cal managed care expertise. Blue Shield will retain Care1st's leadership, culture and business model. Because Blue Shield intends to allow Care1st to continue operating as it has in the past, the fact that Blue Shield has not previously operated in this space is of no consequence. To the contrary, the combination of Care1st's continuing leadership in this area, and Blue Shield's brand and size will only serve to benefit Care1st's membership. Blue Shield's objective is to preserve, invest additional money in, and grow these assets so that Care1st may become even more effective and serve additional Californians according to its new nonprofit mission.

The expenditure of the funds used to purchase Care1st will have no impact on Blue Shield's current business. The expenditure will not affect Blue Shield's ability to comply with the reserve requirements found in California Code of Regulations, title 28, section 1300.76. As indicated in financial statements submitted to DMHC, as of the quarter ended September 30, 2014, Blue Shield has a tangible net equity (TNE) of \$4,149,464,000, with required TNE of \$286,552,000. The \$1.25B transfer does not represent a significant reduction in capital for TNE compliance purposes because of the significant surplus currently maintained. Blue Shield 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 Blue Shield with TNE of \$2,899,464,000. Blue Shield would still have 1,012% of its minimum required TNE, which is still well above the amount held by 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 DMHC for quarter ended September 30, 2014.

Finally, the proposed purchase price of \$1.2B represents fair market value for the acquisition of Care1st. Blue Shield obtained the right to acquire Care1st through a well-organized auction process, which makes the purchase price itself an empirical statement of Care1st's fair market value.

Blue Shield's bid was based on an assessment of Care1st's fair market value as determined by the leading provider of fairness opinions in the country, with which Blue Shield consulted.³ This consultant was completely independent, having provided no other services past or present to Blue Shield and receiving compensation not contingent on the transaction occurring or delivering an opinion with a specified outcome. This valuation utilized three commonly used financial methodologies to establish the proposed purchase price range: comparable companies analysis, comparable transactions analysis, and discounted cash flow analysis. The purchase price offered by Blue Shield for Care1st was within the range of implied values calculated under all of these methodologies.

As an interesting aside, I note that, before the proposed purchase price was announced, Los Angeles Times investigative reporters consulted with healthcare analysts to attempt to identify what Blue Shield might expect to pay for Care1st. The independent analysts' estimate was almost exactly what BlueShield is proposing to pay and, even more notably, was deemed to be an appropriate price:

Ana Gupte, a healthcare analyst at Leerink Partners, said the estimated price of \$1.2 billion that Blue Shield negotiated is appropriate for a health plan specializing in Medicaid. She said that amount "for that size of Medicaid assets sounds reasonable."

Chad Terhune, *Blue Shield seeks to avoid disclosing its price for Care1st*, LOS ANGELES TIMES, March 20, 2015, available at: <http://www.latimes.com/business/la-fi-blue-shield-secrecy-20150321-story.html>, last accessed April 17, 2015.

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To sum up, Article 11 is inapplicable here. It was enacted to ensure that assets held in charitable trust by nonprofit health plans would continue to serve their charitable purposes in the event that the plan converts or restructures to become a for-profit plan. Here, by contrast, Blue Shield holds no assets subject

³ A fairness opinion states that the purchase price is fair to the buyer (here, Blue Shield), from a financial point of view.

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to a charitable trust obligation, and it is not seeking to restructure or convert itself to for-profit status. Quite the opposite, the proposed transaction seeks to convert Care1st into a nonprofit plan in a manner that stands to benefit Californians and is consistent with Blue Shield's mission and purpose.

I hope I have addressed the points that you think are relevant to your inquiries. Of course, I would be happy to address any or all of these issues in greater detail as needed.

Very truly yours,



Seth A. Jacobs

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