



Ms. Shelly Rouillard  
Department of Managed Health Care  
980 9<sup>th</sup> Street, Suite 500  
Sacramento, CA 95814-2725

May 29, 2015

Dear Ms. Rouillard

Our organizations, CalPIRG, Consumers Union, The Greenlining Institute, Health Access, and Western Center on Law and Poverty write to present information and raise a number of issues that we have identified in regard to California Physicians' Service (d.b.a. Blue Shield of California) and its proposal to purchase Care 1<sup>st</sup>, a California for-profit corporation.

Two recent developments have subjected Blue Shield to greater public scrutiny and raised concerns about Blue Shield of California's nonprofit obligations:

- In March 2015, news reports indicated that the Franchise Tax Board revoked Blue Shield's state tax-exempt status in August 2014;
- Blue Shield proposes to purchase the for-profit Medicaid plan, Care 1st Health Plan (and its subsidiaries, in Arizona and Texas), and to establish a nonprofit mutual holding company, Cumulus Holding Company, Inc.

We have identified a number of important issues relating to Blue Shield of California's charitable trust obligations that should be addressed during the Department of Managed Health Care (DMHC)'s review of the proposed transaction. These questions arise from Blue Shield's filings with DMHC in connection with the proposed purchase of Care 1st and more broadly from their loss of tax-exempt status.

In its DMHC filing for a Material Modification, Blue Shield of California states that it "does not currently hold and has not previously held assets subject to a charitable trust obligation."<sup>1</sup> This assertion is contrary to Blue Shield's articles of incorporation, its history, and its stated public purpose. As described more fully below, we contend that its articles of incorporation, its decades-long federal and state tax-exempt status, its decades-long status as a 501(c)(4) organization, and the clear intent of the original founders of the organization, illustrate that Blue Shield holds significant charitable assets subject to charitable trust obligations.

---

<sup>1</sup>Exhibit E-1, DMHC File Number 933-0043, Notice of Material Modification to License Application, January 30, 2015.

DMHC has broad responsibility under California law to determine if Blue Shield holds any charitable assets and ensure that those assets are protected. We believe this issue is critical to determining which parts of the Health and Safety Code apply to DMHC's review of the proposed transaction and warrants intensive scrutiny by the Department.

### Background on California Physicians' Service

The history of California Physicians' Service shows the organization was intentionally established, like virtually all Blue Cross and Blue Shield plans, to protect consumers from the high costs of health care. Furthermore, the California Supreme Court found that California Physicians' Service is a nonprofit corporation subject to the Attorney General's authority over public trusts.

California Physicians' Service was created as a nonprofit corporation in 1939. At the time, California had one general nonprofit corporation law, which included organizations established for "religious, charitable, social, educational, recreational, cemetery, or for rendering services, which do not contemplate the distribution of gains, profits or dividends to the members thereof, and for which individuals lawfully may associate themselves..."<sup>2</sup>

California Physicians' Service was "organized by the medical profession in 1939 to meet the needs of persons in the lower income groups for medical care and surgical service," as a health services corporation.<sup>3</sup> The preamble to the articles of incorporation sets out a summary of the policies and purposes for establishing the nonprofit medical service plan:

[T]hat the very advances made by modern science have greatly increased the cost of good medical service and hospital care and will continue to increase that cost as new methods and equipment for diagnosis and treatment are discovered and perfected, and, therefore, the cost of always unpredictable injury or illness is a financial catastrophe too great to be borne by the few citizens of California thus always afflicted at any given time, though the total cost over any period is within the means of the total group; that a method which only the medical provision can most effectively provide is necessary properly to distribute this cost of medical service so as to relieve the intolerable financial burden heretofore falling on the unfortunate few in any given period of time; that the establishment by the profession of a voluntary medical service plan, participation by all doctors of medicine desiring to do so, will enable people of the State of California to obtain prompt and adequate medical attention and hospital care 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, and will assure that all payments made by patients, except administrative costs, will be***

---

<sup>2</sup> *The Organization of California Physicians' Service*, Hartley F. Peart and Howard Hassard, Law and Contemporary Problems, Vol. 6, No. 4, Medical Care (Autumn, 1939), at page. 567, footnote 11 (citing California's General Nonprofit Corporation Law of 1931).

<sup>3</sup> *California Physicians' Services v. Garrison*, 28 Cal. 2d 790 (1946).

***utilized for medical service and hospital care and not otherwise; that such a plan will create an efficient public and civic service without commercial exploitation of the patients or the profession*** or any restriction of an individual's fundamental right freely to select, when his need arises, the doctor of medicine and hospital desired by him; and finally, ***such a coordinated organized service 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 medical service and hospital care for the indigent, needy or handicapped residents of California.***<sup>4</sup> [Emphasis added]

The California Physicians' Service was created to "form a non-profit, social and civic corporation under the laws of the state of California"<sup>5</sup> based on these ideals, principles and purposes. Specifically, the organization was established to provide quality, affordable health care to low-income Californians through the efficient use of taxpayer funds while ensuring that resources are directed toward the provision of medical care, not profits.

The articles of incorporation themselves reiterated ideas introduced in the preamble, namely that the corporation:

- Does not "contemplate and is not formed for the pecuniary gain or profit of the members thereof or the distribution of gains, profits, or dividends to any of its members;"<sup>6</sup>
- Will "act as trusted under any trust incidental to the principal objects and purposes of the corporation, and to receive, hold, administer and expend funds and property subject to such trust;"<sup>7</sup>
- Will "accept gifts, trusts and donations and receive property by devise or bequest, subject to the laws regulating the transfer of property by will, and to apply the principle or interest as may be directed by the donor or as the board of trustees of the corporation may determine in the absence of such direction, in aid and furtherance of the objects and purposes set forth in [article] TWO."<sup>8</sup>

Soon after California Physicians' Service was established, an article was published in the Journal of Law and Contemporary Problems which was written by counsel to both the California Medical Association and California Physicians' Service. The article, "The Organization of California Physicians' Service," describes the founding of the new nonprofit organization and explains how the founders decided to create a non-profit corporation (as opposed to an insurance company or other business entity), designating three classes of members and the specific rights, roles and responsibilities of each class. California Physicians' Service's counsel acknowledges in the article that the nonprofit corporation holds a charitable trust and is subject to the supervision of the Attorney General's protection of charitable trusts:

---

<sup>4</sup> Articles of Incorporation of California Physicians' Service, Department of State, Corporation Number 178531, Filed with the California Secretary of State, February 2, 1939.

<sup>5</sup> Article Two of the Articles of Incorporation, Ibid.

<sup>6</sup> Article Six of the Articles of Incorporation, Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

It is apparent that an enterprise that collects funds from members to defray the cost of unpredictable medical and surgical needs may, like an insurance company or bank, be considered 'clothed with a public interest,' and, with respect to its administration of such funds, a 'public trustee.' If so, then California Physicians' Service is subject to the control of the California Attorney General. Cal. Civ. Code section 605c (supervision of Attorney General of any non-profit corporation holding property subject to any public trust)."<sup>9</sup>

Approximately seven years later, when the Department of Insurance appealed a lower court determination that California Physicians' Service was not engaged in the business of insurance, the California Supreme Court found that the nonprofit corporation was not providing indemnity insurance. The court looked to the purposes of the corporation and found that California Physicians' Service was organized and maintained with a

[W]ide scope in the field of social service. Probably there is no more impelling need than that of adequate medical care on a voluntary, low-cost basis for persons of small income. The medical profession unitedly is endeavoring to meet that need. Unquestionably, this is a "service" of a high order and not "indemnity."<sup>10</sup>

The court found that California Physicians' Service was subject to the Attorney General's authority over public trusts.<sup>11</sup>

Until 1987, California Physicians' Service and other Blue Cross and Blue Shield (BCBS) Trademark holders, were recognized under federal law as 501(c)(4) organizations. At the time, the national BCBS Association, a nonprofit organization that holds the BCBS trademark, went to great lengths to distinguish BCBS plans from commercial insurers by stressing their dedication to charitable, community-based health care services.

As of January 1, 1987, the federal government removed the full tax-exempt status of BCBS plans because providing commercial insurance was a substantial part of their activities. The IRS created a new category of nonprofit organizations, Internal Revenue Code ("I.R.C.") 5833, or 501(m), which subjected BCBS plans to federal taxation while recognizing the unique role BCBS plans play.<sup>12</sup>

---

<sup>9</sup> *The Organization of California Physicians' Service* at page 573, footnote 39.

<sup>10</sup> *CPS v. Garrison* Ibid.

<sup>11</sup> *CPS v. Garrison* Ibid.

<sup>12</sup> Note that the federal tax status of a corporation does not dictate California's charitable trust rules. In fact, the 501(m) federal tax category was created in 1987 and the Blue Cross of California conversion, subject to full state scrutiny under the charitable trust doctrine, occurred in the 1990s. Indeed, the fact that an organization, such as a health services plan, may not be fully exempt under federal tax law, and therefore may escape IRS scrutiny, makes the application of California charitable trust rules to these entities all the more important-- the state may be the only level of government protecting charitable assets.

In 1994, when the National Blue Cross and Blue Shield Association permitted its affiliated organizations to become for-profit,<sup>13</sup> California Physicians' Service asserted that it intended to remain a nonprofit Blue Cross and Blue Shield licensee. In recent press coverage disclosing the Franchise Tax Board's removal of state tax-exempt status for California Physicians' Service, the health care services plan continued to assert its intent to remain a nonprofit corporation.<sup>14</sup> The corporation currently is organized with the purpose of promoting social welfare.<sup>15</sup>

In light of the Franchise Tax Board's decision to revoke California Physicians' Service's tax-exempt status, whether or not California Physicians' Service can continue doing business as it has and still preserve the charitable trust it has held since 1939, is now in question.

### The Applicable Charitable Trust Law

Under current law, there are three types of nonprofit corporations in California: public benefit, mutual benefit, and religious. Public benefit corporations are organized for charitable (which includes educational or scientific) or public (which includes the broader category of social welfare) purposes.<sup>16</sup> Generally, both types of public benefit corporations are subject to the jurisdiction of the Attorney General and may not engage in mergers, dissolutions, change in corporate status, or other reorganization transactions without the approval of the Attorney General.<sup>17</sup> With regard to health care services plans, California law also gives DMHC wide authority over the nonprofit character and legal obligations of health care service plans, regardless of whether they are categorized as a public benefit or mutual benefit corporation.<sup>18</sup>

All assets of a public benefit corporation are subject to a charitable trust. Mutual benefit corporations—the type which California Physicians' Service is categorized—also may, and often do, hold *part of their assets in charitable trust*, and various sections of the Nonprofit Mutual Benefit Law specifically recognizes this fact.<sup>19</sup> We believe the language previously cited from the articles of incorporation for California Physicians' Service and attendant documents evinces a clear charitable purpose.

### Application of California Physicians' Service's Facts to Charitable Trust Law

California Physicians' Service was created with a public and social welfare purpose. For close to 50 years, it was recognized federally as a 501(c)(4) social welfare organization, free from

---

<sup>13</sup> See Silas, et. al, *Blue Cross Conversions: Consumer Efforts to Protect the Public's Interest*, New York Academy of Medicine (1997).

<sup>14</sup> *Blue Shield of California Loses its Tax Exempt Status*, National Public Radio, March 19, 2015. Accessed at <http://www.npr.org/2015/03/19/393982147/blue-shield-of-california-loses-its-tax-exempt-status>.

<sup>15</sup> The IRS has stated that the promotion of social welfare is a charitable purpose. IRC 501(c)(4) Organizations (2003), page I-25. Accessed at <http://www.irs.gov/pub/irs-tege/eotopici03.pdf>.

<sup>16</sup> Corporations Code Section 5111

<sup>17</sup> In different cases, the corporation must either obtain written approval up front or simply provide notice to the Attorney General, giving it an opportunity to challenge the transaction.

<sup>18</sup> Corporations Code, Section 10821, Health & Safety Code section 1340 et seq.

<sup>19</sup> Corporations Code Sections 7238 and 7820.

taxes, able to accept tax-deductible donations, and receive special treatment from the federal government. During that same span of time, under California state law, California Physicians' Service was organized and incorporated under the state general nonprofit code, as a "religious, charitable, social, educational, recreational, cemetery, or for rendering services, which do not contemplate the distribution of gains, profits or dividends to the members thereof, and for which individuals lawfully may associate themselves..."<sup>20</sup>

When the nonprofit law changed in 1980 to become more specific about the type of nonprofits—religious, public benefit, or mutual benefit—the Secretary of State's office classified all pre-1980 corporations according to the category that they most closely resembled. Given the vast number of nonprofit corporations, it is unlikely that any substantial level of analysis of each corporation was undertaken, and it may be that some entities, and perhaps California Physicians' Service is one, were simply misclassified as a mutual benefit corporation, while most other health care service plans were characterized as public benefit corporations (including Blue Cross of California and Kaiser Permanente). At the time, California Physicians' Service did not change its articles of incorporation or by-laws, but continued to do business under the same purposes as it originally articulated in 1939.

It seems implausible that one health care service plan, such as Blue Cross of California (originally a nonprofit public benefit corporation before its conversion to for-profit in the 1990s, now known publicly as "Anthem"), could be subject to the charitable trust rules, while another, such as California Physicians' Service, would not, even though both entities did the same basic work and were governed as nonprofits under the same general California nonprofit law for close to 50 years. The difference in the Secretary of State's classification may be attributable merely to the choice of a few words (in this case possibly the word "members") in the articles of incorporation.

If the provision of comparable health care services is a public benefit charitable activity for some nonprofit corporations, then it must be for all, even those that happen to be organized as mutual benefit corporations. Since most nonprofit health care service plans are public benefit corporations with charitable assets, all nonprofit health care service plans must be treated in the same way. Otherwise, the disparate treatment would provide the mutual benefit corporations with an unfair competitive advantage. The purposes and activities of California Physicians' Service and other mutual benefit health care service plans are not generally different from the charitable purposes and activities of Blue Cross, HealthNet, and other public benefit corporations and which were subject to the charitable trust rules until they converted to for-profit corporations.

Any argument that Blue Shield of California, which engages in exactly the same type of charitable or public activity as these other health care plans, should escape the charitable trust rules is illogical. As a general rule, California law, and all laws, should seek to elevate substance

---

<sup>20</sup> *The Organization of California Physicians' Service*, Ibid at page. 567, footnote 11 (citing California's General Nonprofit Corporation Law of 1931).

over form. It is, in part, for this reason the Mutual Benefit Code recognizes that mutual benefit corporations may have charitable assets,<sup>21</sup> and that those assets will be subject to the charitable trust rules.<sup>22</sup>

### Charitable Trust Obligations Apply Regardless of How Blue Shield Frames Corporate Structure

Charitable trust restrictions, once imposed, continue to apply to assets impressed with a charitable trust even if a corporation later changes its purposes, dissolves, and distributes its assets, or transfers its assets to another charity without receiving full consideration. Charitable trust restrictions, once imposed, also continue to apply to the proceeds from the sale or lease of any charitable assets.<sup>23</sup> Given that Blue Shield's charitable assets must always be preserved and that charitable trust restrictions apply indefinitely, the obligation on Blue Shield to accumulate and use assets in a prescribed manner applies today, regardless of how it attempts to reframe its corporate structure.

We have seen a number of creative business arrangements of other Blue Cross and Blue Shield plans. The proposed transaction between Blue Shield and Care 1st is a complicated one. It involves setting up a new nonprofit corporation, Cumulus Holding Company, and having Blue Shield "grant" \$1.25 billion to that new company so that the new company can buy all the shares of a for-profit company, Care 1st. There are many details about the proposed purchase and about how the three companies will co-exist as affiliates after the transaction, which includes, among other things, a shared Board of Directors. The transaction requires great scrutiny to ensure that Blue Shield's nonprofit assets are protected and preserved.

Restructuring and conversions of Blue Cross and Blue Shield plans are never simple. In many cases, when these types of transactions were first proposed by other Blue Cross and Blue Shield plans across the country, they were not overtly engaging in restructuring or conversion. In our own backyard, in the 1990s when California Blue Cross converted from nonprofit to for-profit status, it did not explicitly state its intention to convert from a nonprofit to a for-profit. Rather the proposal was for the nonprofit to create a for-profit subsidiary. Only after careful scrutiny from the public, the media, and diligent regulators over a period of time and investigation, did it become clear that the proposal was actually a conversion; a conversion that at the end resulted in more than \$3 billion of nonprofit assets set aside in two charitable foundations, based on the charitable trust doctrine.

On the face of it, Blue Shield's proposal to purchase the for-profit Care 1st is quite similar to Blue Cross of California's transaction. Blue Cross of California proposed to *create a for-profit* with some of its assets. Blue Shield is proposing to *purchase a for-profit*. In the 1990s, the regulator successfully protected the charitable assets of Blue Cross that had accrued for over 50 years. (That experience was the genesis of the Health & Safety Code, Article 11, relevant to Blue Shield's proposed transaction.) The public deserves the same level of scrutiny from regulators today to ensure that nonprofit, charitable assets of Blue Shield of California are protected similarly.

---

<sup>21</sup> Corporations Code Section 7111

<sup>22</sup> See also, Health & Safety Code Section 1399.75(e).

<sup>23</sup> *Pacific Homes v. County of Los Angeles*, 41 Cal.2d 844, 854 (1953).

## DMHC Role in Protecting Charitable Assets

The Department's responsibility to protect charitable or public assets is more than a ministerial responsibility. The California Health & Safety Code charges this Department with the obligation to protect charitable assets held by health service corporations, including Blue Shield of California. Whether it is a restructuring, conversion or a simple material modification, the DMHC must ensure that charitable assets of health service corporations continue to be used to further their original purposes, and no other.

Blue Shield of California should bear the burden of proving its assertion that it "does not currently hold and has not previously held assets subject to a charitable trust obligation."<sup>24</sup> Its articles of incorporation, its history, and its stated public purpose, its decades-long federal and state tax-exempt status, its decades-long status as a 501(c)(4) organization, and the clear intent of the original founders of the organization, all indicate otherwise, i.e. that Blue Shield of California holds significant charitable assets subject to charitable trust obligations. It should not be able to evade the Health and Safety Code's protections, and any other duties under California law, by simply asserting it has no such charitable trust obligation.

Although Blue Shield of California does not characterize its purchase of the for-profit Care 1<sup>st</sup> through a newly created nonprofit as a restructuring or conversion, DMHC still bears responsibility for protecting Blue Shield's charitable assets. Since Blue Shield claims in its filings for the Care 1<sup>st</sup> transaction that it does not now, nor has it ever held any charitable assets, advocates are very concerned that assets of Blue Shield may not be protected, preserved and used as they should be, whether in the context of the proposed purchase of Care 1<sup>st</sup> or otherwise. At the beginning of 2014, Blue Shield of California held a surplus in excess of \$4 billion, well above the amount required by the state and the BCBS Association. It added to that surplus in 2014 and raised insurance premiums in 2015 with a clearly stated intent to grow additional surplus.<sup>25</sup> DMHC should ensure that the surplus is used consistent with the charitable trust doctrine.

Also in the material modification filing, Blue Shield has said it is purchasing Care 1<sup>st</sup> because it wants to be in the Medi-Cal market. Blue Shield claims that the purchase of Care 1<sup>st</sup> will further Blue Shield's mission to serve low-income people. Just because Blue Shield is proposing to purchase a for-profit company that serves poor people, does not in anyway release the company from DMHC scrutiny to ensure that its charitable assets are protected.

We look forward to hearing from Blue Shield of California how the revocation of its tax exempt status, the proposed grant of more than one billion dollars to a new affiliated holding company that will then purchase the shares of Care 1<sup>st</sup> (which will become another affiliated company), and the claim that Blue Shield does not now nor has it ever held any charitable assets, can be reconciled with the history and facts of this long-standing California nonprofit corporation.

---

<sup>24</sup> Exhibit E-1, DMHC File Number 933-0043, Notice of Material Modification to License Application, January 30, 2015.

<sup>25</sup> The California Physicians' Services actuarial memorandum stated their intent to increase contribution to surplus from 1.15% to 1.95% of revenue.



If you have any questions or concerns, please contact Julie Silas (415) 431-6747 ext 106 or [jsilas@consumer.org](mailto:jsilas@consumer.org).

Sincerely,

Emily Rusch, CalPIRG  
Julie Silas, Consumers Union  
Tahira Cunningham, Greenlining Institute  
Tam Ma, Health Access  
Elizabeth Landsberg, Western Center on Law and Poverty