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MEMORANDUM

TO: U.S. Chamber of Commerce

FROM: Morgan, Lewis & Bockius, LLP

DATE: October 21, 2003

SUBJECT: California's Health Insurance Act of 2003

This memorandum briefly analyzes possible challenges to California's Health Insurance Act of 2003 ("SB2") and highlights only the major issues and legal arguments related to such challenges.

I. SB2

- SB2 was signed into law by Governor Gray Davis on October 5, 2003.
- SB2 is described as "pay or play" legislation, and requires employers to pay a fee to the California State Health Purchasing Fund (the "Fund") to be used to purchase state provided and administered health insurance for California workers. The fee will be assessed to each employer based on the number of workers the employer has in its workforce who are eligible for the state provided health insurance.
- Employers can receive an exemption from the fee by demonstrating proof of equitable healthcare coverage. Employer provided health insurance that meets certain requirements set forth in SB2 and generally any collectively bargained health insurance plan are considered equitable coverage under the legislation.
- SB2 is effective as of January 1, 2006 for large employers (generally defined under SB2 as a private entity employing 200 or more workers in California).

II. Employee Retirement Income Security Act ("ERISA") Preemption

A. ERISA Preempts SB2

The United States Supreme Court (the "Court") has held that state laws mandating benefits that directly or indirectly "relate to" or reference an ongoing welfare plan regulated by ERISA are preempted by ERISA. See e.g., District of Columbia v. Greater Washington Bd. of Trade, 506 U.S. 125 (1992) (District of Columbia's workers' compensation law requiring employers that provide employee health insurance also provide equivalent benefits to employees eligible for workers' compensation benefits is preempted by ERISA); Shaw v. Delta Airlines, Inc., 465 U.S. 85 (1983) (state disability law is preempted by ERISA as applied against airlines providing disability benefits through a multi-benefit ERISA plan). In articulating its ERISA preemption

analysis as applied to state laws mandating benefits, the Court has said that a state law which ties its mandated benefits directly to those benefits provided under an ongoing ERISA plan is preempted. Greater Washington Bd. of Trade, 506 U.S. 125. Although ERISA does not preempt state insurance laws mandating benefits to be provided through insured employee benefit plans, SB2 is not saved from preemption because it is not limited to insured employee benefit plans, nor is it a state insurance law.

An argument can be made that SB2 mandates the level of health care benefits provided by employers through the credit that is offered if an employer's benefit plan meets the requirements of SB2. Because the availability of the credit is measured against the level of benefits provided under an employer's ongoing benefit plan that may be regulated by ERISA, the Court could find, applying its reasoning in Greater Washington Bd. of Trade, that SB2 is preempted under ERISA. That said, California could avoid preemption under ERISA by eliminating the credit and thereby eliminating any reference to an employer's benefit plan in the legislation.

B. Countervailing Argument

The Court's opinions with respect to ERISA preemption of state laws mandating benefits are inapplicable because SB2 merely assesses a fee that can be avoided by provision of employer-based health care benefits. The Court has upheld state laws imposing taxes or fee assessments against purchasers of hospital services as laws that do not impermissibly "relate to" ERISA plans within the meaning of ERISA's preemption provisions. See e.g. DeBuono v. NYSA-IL Medical and Clinical Svcs. Fund, 520 U.S. 806 (1997) (state tax on gross receipts of health care facilities is not preempted by ERISA); New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Plan, 514 U.S. 645 (1995) (surcharges on hospital rates imposed on patients and HMOs is not preempted by ERISA). The Court has reasoned that a tax or fee assessment imposed on patients, healthcare facilities and/or commercial insurers does not directly or indirectly affect any choices to be made by an ERISA plan with respect to the provision or administration of benefits and, therefore, does not impermissibly "relate to" an ERISA plan. Id. In other words, ERISA preemption is not triggered where the state law only affects the choices of those against whom the fee or tax is assessed. Id.

SB2 only imposes a fee on employers. The existence of an employee benefit plan is relevant only in determining whether the employer is entitled to a "tax" credit for maintaining equitable insurance coverage under its own plan. Therefore, the fees imposed by SB2 on employers are analogous to the fees or taxes assessed against patients, healthcare facilities and/or commercial insurers, insofar as the fee assessment may influence an employer's decision whether or not to provide a plan that complies with SB2. If the Court takes this approach in its analysis of the present case, SB2 is likely to withstand an ERISA preemption challenge.

C. Conclusion

Although we can argue that SB2 impermissibly prescribes the level of benefits provided by ERISA plans and, therefore, is preempted, we believe that the Court is more likely to construe SB2 as imposing permissible fees on employers for the provision of state administered health insurance, following its reasoning in the DeBuono and Travelers Insurance Company cases. On balance, therefore, we believe that SB2 is likely to withstand an ERISA preemption challenge.

III. National Labor Relations Act ("NLRA") and Railway Labor Act ("RLA") Preemption

An employer can receive a credit against its fee assessment under SB2 by demonstrating that it maintains a collectively bargained employee health plan, thereby negating any preemption challenge under the NLRA or RLA.

IV. Invalidity Under California Constitution, Article XIII A, Section 3

Article XIII A, Section 3, of the California Constitution ("Section 3") requires that any new state "tax" be approved by a two-thirds (2/3) majority of each house of the California Legislature. If the "pay or play" provision of SB2 imposes a "tax" on employers who decline to "play" by providing employee health insurance coverage, SB2 was not validly enacted because it was not passed by the requisite supermajority of both houses. However, if SB2 merely imposes a "regulatory fee" on employers who decline to provide employee health insurance coverage, Section 3 does not apply.

A. SB2 is an Invalid Tax

Although the California Legislature has attempted to give SB2 the dressing of a regulatory fee, it does not fit into satisfy the characteristics of a "regulatory fee:" (1) it does not impose assessments on those who will receive a benefit, directly or indirectly, from use of the Fund; and (2) it does not impose assessments on those whose activities or operations cause or contribute to the problems to be mitigated by use of the Fund.

SB2 assessments do not fall within the first category of regulatory fees because payers will not receive a distinct benefit, directly or indirectly, as a result of the Fund. Rather, any benefits employers will derive from use of the Fund will be the same as the benefits to be derived by members of the California public as a whole.

SB2 assessments do not fall within the first category of regulatory fees because the Fund will not seek to mitigate a social ill caused by the employment relationship between medium and large employers and their employees who work a minimum number of hours per month. Rather, SB2 seeks to remedy the broader social problems arising from the lack of affordable access to health care through group health insurance. See, SB2, § 1. Although SB2 contains Legislative findings that "most working Californians obtain their health insurance coverage through their employment," and "80 percent of Californians without health insurance coverage are working people or families," SB2, §§ 1(b) & 1(d); it fails to memorialize a single finding that employment, or the employment relationship, causes or contributes to the lack of affordable access to health care.

In Sinclair Paint Co. v. State Board of Equalization (1977) 15 Cal.4th 866, 878, the first published case to address whether a state assessment was a "tax" subject to Section 3 or was a "regulatory fee," the Sinclair Paint Company challenged the validity of an assessment under the Childhood Lead Poisoning Prevention Act of 1991 ("CLPPA"). Under the CLPPA, assessments are imposed on manufacturers and others engaged in commerce involving lead and lead-containing products based on their "market share" of such commerce, and are used to fund a state-wide program of child lead poisoning detection and treatment.

In finding that a CLPPA assessment is a regulatory fee imposed by the state's police powers, the Court noted that such power "is broad enough to include mandatory remedial measures to mitigate the *past, present or future* adverse impact of the fee payer's operations, at least where, as here, the measure requires a causal connection or nexus between the product and its adverse effects." Sinclair, supra, at 877. The Court also found that the CLPPA did "regulate" its payers in that "[i]t requires manufacturers and other persons whose products have exposed children to lead contamination to bear *a fair share* of the cost of mitigating the adverse health effects their products created in the community." Id. (emphasis added). Finally, the Court expressly noted that Sinclair Paint would have another chance to challenge CLPPA assessments:

> Sinclair will have the opportunity to try to show that no clear nexus exists between its products and childhood lead poisoning, or that the amount of the fees bore no reasonable relationship to the social or economic "burdens" its operations generated.

Id., at 881.

As the language of Sinclair demonstrates, where the assessment does not confer a benefit on the payer, a regulatory fee can exist if there is a nexus between the payers and their operations and the social problem(s) the assessment seeks to mitigate or remedy. Unlike the CLPPA assessments challenged in Sinclair, SB2 assessments on employers will bear no relationship between their operation and the social problem of the lack of affordable access to health care. Accordingly, SB2 does not regulate. Rather, it taxes employers in order to fund a program aimed at mitigating a social problem that bears no relationship whatsoever to the employment relationship or to the operations of "employers."

B. Countervailing Argument

It is well-established that the police power is "the inherent reserved power of the state to subject individual rights to reasonable regulation for the general welfare." Sinclair Paint Co. v. State Board of Equalization (1977) 15 Cal.4th 866, 878, citing, 8 Witkin, Summary of Cal. Law (9th ed. 1988) Constitutional Law § 784, p. 311. Consistent with the Legislative findings of SB2, there can be no doubt that increasing the number of persons who have health insurance coverage, and spreading the costs of such coverage among employees and their employers, are consistent with the general welfare and will benefit employees and employers, directly and indirectly.

In Sinclair Paint Co., supra, the California Supreme Court endorsed an broad view of a "regulatory fee." Critical to its holding that the assessments under the CLPPA constituted a regulatory fee, were the Court's findings that the CLPPA:

- generates revenue to be used only for the program;
- generates revenue in amounts sufficient only to defray or pay for the reasonable costs, direct and indirect, of the program; and
- regulates businesses that involve lead by requiring them to help mitigate the past, present and future adverse social effects of their operations, and by incenting those businesses to develop non-lead containing products in order to avoid or decrease future assessments.

Like assessments under the CLPPA, SB2 assessments satisfy each of these elements and constitute a “regulatory fee” imposed by the state under its police, not tax, power. Revenue generated from SB2 assessments are required to be sufficient to pay for, and are to be used only for, the direct and indirect costs of the newly-created State Health Purchasing (“SHP”) Program. SB2, § 2, Labor Code § 2140.1. The assessments are to be paid by employers and contributions are to be paid by employees who will benefit, either directly or indirectly, from the SHP Program. Id. Finally, because employer assessments will be based on the number of their employees and their dependents who will be potentially enrolled in the SHP Program, id., § 2, Labor Code §§ 2140.5–2140.7; they will be required to bear their fair share of the cost of the SHP Program.

C. Conclusion

The weight of case law authority is in favor of a finding that SB2 imposes a “regulatory fee” and not a “tax” subject to Section 3. A challenge to SB2 under Section 3 necessarily will require a greater focus on the parameters of the state’s police power than exists in the published cases. Because no published opinion has expressly addressed whether a regulatory fee can exist if it is imposed on those who do not receive a distinct benefit from the government’s use of the fee,[1] or on those who do not cause or contribute to the social problem the fee is intended to mitigate or remedy, a challenge to SB2 under Section 3 will present a new issue to the courts.

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[1] SB2 contrasts sharply with SB 1661, signed into law in September 2002 which established a Family Temporary Disability Insurance (“FTDI”) Benefit as part of California’s State Disability Program. The only assessments to be made under that law are on employees who will be the direct beneficiaries of the FTDI Benefit. No assessments or contributions are paid by employers to help fund FTDI Benefits.