Wood LLP

ATTORNEYS AT LAW

333 SACRAMENTO STREET
SAN FRANCISCO, CA 94111-3601
TEL. 415.834.1800 FAX 415.834.1888
www.WoodLLP.com

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January 17, 2012

VIA FACSIMILE AND
FIRST CLASS MAIL

Mr. Blake Cunningham
Protest Unit, State of California Franchise Tax Board
P.O. Box 1286
Rancho Cordova, CA 95741-1286
Facsimile: 916-843-0168

Re: 392:BEC:F380
Additional Information related to Camino Medical Group's Shadow Fund

Dear Mr. Cunningham:

Thank you for sending your letter, dated January 6, 2012, setting the protest hearing for Camino Medical Group ("CMG") on February 8, 2012 in Sacramento. We appreciate you taking the time to meet with us and discuss both the factual and legal bases for CMG's non-receipt of $10,179,658 in 2005 related to certain deferred compensation arrangements established in 2000. This disputed $10,179,658 (the "Shadow Fund"), along with other similar deferred compensation collected by CMG's affiliate, Palo Alto Medical Foundation ("PAMF"), never accrued to CMG's benefit – in fact, CMG never received one dollar of that amount!

The purpose of this letter is three-fold. First, we wish to provide you with a more detailed written explanation of the relationship between CMG and PAMF and the arrangement that has given rise to the Shadow Fund now in question. Second, although we have previously provided you with our arguments, we believe it is important to provide again the three distinct legal rationales showing that the Shadow Fund does not represent income to CMG in 2005. Finally, we would like to provide you with additional documents that will elucidate the facts and law of the Shadow Fund.

STATE BOARD OF EQUALIZATION
Appeal Name: Camino Medical Group Inc.
Case ID: 719011 ITEM #: B2
Date: 4-22-14 Exhibit No:
TP FTB DEPT PUBLIC COMMENT

TAXPAYER EXHIBITS
B2
April 22, 2014
Camino Medical Group, Inc.
719011

A. <u>Documents Previously Provided</u>

In our Protest to the Notice of Proposed Assessment, dated April 5, 2011 (the "Protest"), we sent you three documents providing the basic relationship between CMG and PAMF. These included the following:

1. The Affiliation Agreement ("Affiliation Agreement"), effective as of June 1, 2000 between PAMF, Sutter Health and CMG. This document and its exhibits were labeled Exhibit C in our April 5, 2011 Protest.

2. The Agreement for Professional Services ("PSA"), pursuant to which CMG would furnish the services of its physicians through a division of PAMF. This document was labeled Exhibit D in our April 5, 2011 Protest.

3. The Deferred Compensation Agreement, memorializing a mechanism by which CMG would request from PAMF only such funds as would be required to meet CMG's current expenditures. This document was labeled Exhibit E in our April 5, 2011 Protest.

B. <u>Refined Description of the Shadow Fund</u>

The three documents previously provided to you created the initial affiliation and relationship between CMG and PAMF. This relationship was effective as of June 1, 2000. The Affiliation Agreement states that CMG would contract to provide physician and other services exclusively to PAMF and would be responsible for its own operations and personnel. See Affiliation Agreement § 3.1.

Among its various provisions, the Affiliation Agreement also required PAMF to collect certain CMG accounts receivable (the "Old A/R") that were earned by CMG prior to the affiliation. See Affiliation Agreement Exhibit 1.2. PAMF did collect the Old A/R and, after retaining a collection fee, paid them over to CMG. CMG maintained an accurate record of the collections of the Old A/R, $10,179,648, until they were paid in full in September 2000.

Shortly before the effective date of the June 1, 2000 affiliation, CMG CEO Dr. Richard Slavin (on behalf of CMG) and PAMF CEO Dr. David Druker (on behalf of PAMF) became concerned about the 'cash crunch' that would develop for PAMF in the first few months of the affiliation between CMG and PAMF. Even though CMG physicians would be seeing patients and thereby generating accounts receivable for PAMF, there would be a mismatch of cash payments resulting in a cash shortfall. PAMF would be responsible for paying CMG compensation from the outset of the relationship, yet these new accounts receivable would not be reduced to cash for several months.

Both men recognized that CMG would need cash to fund payroll for its employed physicians and support staff. To address this concern, Drs. Slavin and Druker entered into an oral agreement (the "Oral Agreement"), negotiated at arm's length. The Oral Agreement provided that CMG would use the Old A/R as it was collected to fund its operations. The Oral Agreement also contemplated that an amount of compensation equal to the Old A/R (the Shadow Fund) – which would otherwise have become payable to CMG on account of the work it would perform for PAMF pursuant to the PSA – would be withheld from CMG and made available to CMG on the following terms.

The Shadow Fund would be retained by PAMF and set aside on PAMF's books (but still subject to the claims of general creditors). It was also agreed that the Shadow Fund would bear interest, and would only be due and payable upon a termination of the PSA relationship. In this respect, the Oral Agreement can logically be viewed as an amendment to the Deferred Compensation Agreement. Of course, these doctors who worked closely together and had mutual trust, never got that 'legalistic'. The doctors agreed that no later than five years after the affiliation of CMG and PAMF, or 2005, CMG would be put to an election.

CMG might choose to deepen its affiliation with PAMF and forgive PAMF's obligation to pay the Shadow Fund (and other deferred compensation) over to CMG. This would allow PAMF to use the money to invest in its expanded business operations. Alternatively, the relationship would terminate and CMG would be paid the Shadow Fund. If this would occur, CMG would have a source of funds to re-establish itself as an independent, fully functioning health care provider.

The Shadow Fund was carefully tracked and accounted for. By the end of 2005, the Shadow Fund amounted to $10,179,648, the exact amount of the Old A/R, just as had been agreed. To summarize, the Oral Agreement addressed the collection of an amount of post-affiliation PAMF earnings equal in amount to the Old A/R, and this amount would have been paid to CMG, but for the Oral Agreement. These post-affiliation earnings make up the Shadow Fund, the subject of the Notice of Proposed Assessment.

In 2005, CMG, through its Board of Directors, affirmed that the affiliation with PAMF created the type of working relationship and environment that was ideal for its physicians and their patients. Accordingly, under the terms of the Oral Agreement, CMG released and extinguished its still-contingent right to the Shadow Fund. Thus, PAMF retained for itself the unpaid balance of the Shadow Fund, prior to such balances being due and payable to CMG. Significantly, because the Oral Agreement was entered *before* any of the funds with which it was concerned were ever collected, CMG never had a right to be paid any portion of the Shadow Fund.

C. Recitation of Arguments for Appropriate Tax Treatment of Shadow Fund

As we will discuss in more detail at our meeting, there are at least three independent legal bases confirming that the $10,179,658 Shadow Fund does not constitute income to CMG in 2005. First, CMG never had actual or constructive receipt of such funds in 2005. Clearly, CMG had no actual receipt of the Shadow Fund since it never received one dollar of that amount. In addition, CMG did not have constructive receipt of such funds. It is true that the Shadow Fund increased throughout the five years of the PSA under the terms of the Oral Agreement.

However, throughout this time, PAMF held the Shadow Fund in a general fund. It was at all times subject to the claims of PAMF's general creditors. As such, PAMF's obligation to pay CMG the Shadow Fund upon the termination of the affiliation amounted to no more than a mere promise to pay funds. It was not even represented by notes or otherwise secured. There is unequivocal precedent that a mere promise to pay does not constitute constructive receipt to the promisee. See *e.g.* Rev. Rul. 60-31, 1960-1 C.B. 174, 177.

Second, in the event that CMG can somehow be said to have had constructive receipt of the Shadow Fund in 2005 (which we dispute), CMG must be viewed as forfeiting its right to such funds. CMG never received any portion of the Shadow Fund. Such a forfeiture is best characterized as a payment intended to prevent injury to CMG's business relationship with PAMF.

Numerous authorities demonstrate that payments made to prevent injury to a taxpayer's business are deductible as ordinary and necessary business expenses. See Private Letter Ruling 200247004 (July 29, 2002) for a survey of these authorities. Thus, if CMG can somehow be said to have had receipt of the Shadow Fund, its forfeiture to PAMF represents a payment motivated by business exigencies that is properly deductible as an ordinary and necessary business expense in 2005. The result is no change to CMG's California income tax liability.

Third, the Shadow Fund, if it ever was income to CMG, was properly income in tax year 2000. The Old A/R, in the amount of $10,179,648, was collected in September 2000 by PAMF. The Oral Agreement between Drs. Slavin and Druker provided that the Shadow Fund (in an amount equal to the Old A/R) would be withheld by PAMF as deferred compensation for CMG.

Thus, the income from the Old A/R – *i.e.* the Shadow Fund –accrued to CMG in 2000 when PAMF collected the $10,179,648 on behalf of CMG. Since tax year 2000 was outside the scope of the IRS's original determination, R&TC Section 19057 controls the period for proposing a deficiency. The Franchise Tax Board is now barred from assessing tax from CMG for taxable year 2000.

D. Additional Documentations Related to Shadow Fund

In order to provide you with a more substantive understanding of the nature of the Shadow Fund, we are providing additional documents. All of these documents were previously shared with the Internal Revenue Service as part of their no change examination of CMG's federal income tax liability for tax year 2005.

1. **CMG Board of Directors Meeting Minutes from 2005.** We have enclosed the CMG Board of Directors meeting minutes from September and November 2005 related to the Shadow Fund as Exhibit F.[1] These meeting minutes describe the evolution of CMG's understanding of the Shadow Fund. While the meeting minutes do not explicitly reference the Oral Agreement, they demonstrate that CMG never understood itself to have receipt of (or an unconditional right to receive) the Shadow Fund.

   In particular, the meeting minutes from the November 8, 2005 meeting indicate that the CMG Board of Directors had elected to "[f]orgive the PAMF obligation to pay CMG the $10M collected on its Accounts Receivable from June 2000." As described above, the "$10M" described in the meeting minutes actually represents the Shadow Fund agreed to under the terms of the Oral Agreement. Significantly, the meeting minutes from the November 8, 2005 meeting show that such funds were received in 2000. In addition, the meeting minutes make clear that CMG never had receipt of such funds and that PAMF continued to hold the Shadow Fund at all times.

2. **Memorandum from Richard DeFronzo to David McCanna, dated September 14, 2005.** We have enclosed a memorandum from CMG's accountant to CMG's controller as Exhibit G. The memorandum describes the Shadow Fund as the "$11 million related to the opening patient accounts receivable" and indicates that the disposition of such Shadow Fund must be addressed. This memorandum is entirely consistent with the CMG Board of Directors Meeting Minutes. This memorandum also corroborates that the Shadow Fund accrued to CMG, if at all, in 2000. Additionally, the memorandum confirms that CMG did not have any access to the Shadow Fund between 2000 and 2005.

3. **Memorandum from Shelly Boehm to Colette Boudreau, dated December 8, 2005.** We have enclosed a memorandum from Sutter Health's (PAMF is an affiliate of Sutter Health) controller to Sutter Health's accountant, Ernst & Young as Exhibit H. This memorandum indicates that the CMG "needed to decide whether to be paid or forgive the" Shadow Fund. The memorandum provides

[1] In the interest of clarity, we have continued the alphabetical list of Exhibits from our April 5, 2011 Protest.

that CMG elected to forgive the Shadow Fund as well as other deferred compensation. Significantly, this memorandum concludes that PAMF would book the $10,179,648 of Shadow Fund as a credit in November 2005.

4. **Memorandum from Thomas Driscoll to Kate Heinemann, dated March 19, 2009**. We have enclosed a memorandum from CMG's attorney Tom Driscoll to Kate Heinemann of the Internal Revenue Service as Exhibit I. This memorandum provides a detailed explanation of the Shadow Fund and the Oral Agreement. Significantly, this memorandum includes an important clarification of the December 8, 2005 memorandum from Shelly Boehm to Colette Boudreau.

   In particular, the memorandum indicates that the Shadow Fund was the subject of the Oral Agreement. Additionally, the memorandum includes a portion of CMG's accounting records (the "Deferral Schedule") tracking the existence and disposition of the Shadow Fund.

5. **Letter from David Porter to Salenshni Anand, dated October 12, 2010**. We have also enclosed a letter from David Porter, previously of our law office, to Salenshni Anand of the Franchise Tax Board as Exhibit J. This was our first substantive correspondence with the Franchise Tax Board and provides an initial overview of our arguments regarding the non-receipt of the Shadow Fund.

We hope the information provided herein and the attached materials are of assistance to you. Please do not hesitate to contact me directly if you have any questions about this letter or its exhibits.

Kind regards,

Wood LLP

Christopher A. Karachale

CAK:ce
Enclosures
ZD340.4

cc: Thomas L. Driscoll
Robert W. Wood

Camino Medical Group
BOARD OF DIRECTORS MEETING
September 6, 2005

Present: Drs. Aigen, Brosterhous, Kristensen, Morikawa, Rubinstein, Strichartz, Tai and Vilardo

TOPIC	DISCUSSION	ACTION
CMG Deferred Compensation	Dr. Aigen led a discussion about the need to reduce deferred CMG compensation by at least $20M. A long discussion ensued prompted by a voice message left by Dr. Slavin who was unable to attend the meeting about possible ways of using the CMG deferred compensation.	No Board action was taken. The Board wished to hear more from Dr. Slavin and Sharon Kutis regarding possibilities for use of the CMG deferred compensation.
Palo Alto Medical Foundation Integration	Dr. Aigen led a discussion regarding possibilities for integration and discussion was sparked by the recent combined Board meeting.	No Board action was taken.
Cardiology Update	Dr. Aigen presented 5 points in a handout from Cardiology for Board consideration including some changes in the methodology that the Compensation Committee uses to make market adjustments.	No Board action was taken.
Compensation Committee Draft	Dr. Aigen presented a draft from the Compensation Committee for changes in how compensation is adjusted based on market.	No Board action was taken.
Compensation Incentive	Dr. Aigen led a discussion of the possibility for incentivizing productivity and quality. A long Board discussion ensued.	No Board action was taken.

Respectfully submitted,

Torben Kristensen, M.D.
Secretary, Board of Directors

EXHIBIT F

Camino Medical Group
BOARD OF DIRECTORS MEETING
September 13, 2005

Present: Drs. Aigen, Brosterhous, Kristensen, Morikawa, Rubinstein, Slavin, Strichartz, Tai and Vilardo

TOPIC	DISCUSSION	ACTION
Quality and Productivity Incentive Plan	Dr. Aigen presented a plan to incentivize quality and productivity by the shareholder and shareholder track physicians in the group, including monetary compensation with increased RVUs for greater than 75% producers and financial bonuses for physicians with high quality in both patient satisfaction and peer review and for physicians who increase patient satisfaction and peer review by certain amounts. A discussion ensued.	No Board action was taken.
Blue Cross Contract Update	Dr. Slavin informed the Board that a contract has been signed with Blue Cross for 2005 and 2006 retroactive to January of 2005.	No Board action was taken.
Differed Compensation Discussion	Dr. Slavin led a discussion of differed PSA and the need to decrease the amount of differed PSA on the books in order to obtain bond financing. Dr. Slavin suggested the possibility of creating a Camino Division Capital Fund at Palo Alto Medical Foundation into which some of the differed PSA could be placed for capital projects for the Camino Division. In addition, some of the differed PSA it was suggested could be paid to the physicians in 2005 as well as some of the differed PSA being added to the medical malpractice fund. A long discussion ensued.	No formal Board action was taken.

Respectfully submitted,

Torben Kristensen, M.D.
Secretary, Board of Directors

EXHIBIT F

Camino Medical Group
BOARD OF DIRECTORS MEETING
September 20, 2005

Present: Drs. Aigen, Kristensen, Morikawa, Rubinstein, Slavin, Strichartz, Tai and Vilardo

TOPIC	DISCUSSION	ACTION
12 month Interview with Dr. Cindy Leong	Dr. Leong is doing well and has no complaints.	No Board action was taken.
Stipend for Los Gatos Project	Dr. Aigen suggested a $5,000 stipend for Dr. Stuart Menaker for his work on the Los Gatos project.	The Board approved this suggestion by Dr. Aigen.
Ophthalmology Center Stipend	Dr. Slavin informed the Board that Dr. Barbara Erny will be the new Medical Director for the Ophthalmology Surgery Center and will receive a $1,000 per month stipend.	No Board action was taken.
New Secure Horizons Contract	Dr. Slavin informed the Board that a new Secure Horizons contract was signed with a 3% net increase over 2004.	No Board action was taken.
Philanthropy Update	Dr. Slavin gave an update of new hires in the Philanthropy Department.	No Board action was taken.
PSA Allocation	Dr. Slavin gave a detailed handout and invited discussion regarding his recommendations for allocation of non-distributed PSA including recommendations for $5M for the Risk Retention Fund and creation of a Capital Projects Fund within the Palo Alto Medical Foundation and also distribution to physicians of 8-10% over budget.	The Board approved these plans as presented by Dr. Slavin, pending approval from Sharon Kutis and the PAMF Board.
12 month Interview with Dr. Michael Lim	Dr. Lim came for his 12 month interview with no complaints. He is doing well.	No Board action was taken.
Quality and Productivity Incentives	Dr. Aigen led a short discussion regarding quality and productivity incentives.	No Board action was taken.
Architects Meeting	The Board met with the architects and John Holm to discuss the reasons for a delay in continued construction on the site.	No Board action was taken.

Respectfully submitted,

Torben Kristensen, M.D.
Secretary, Board of Directors

EXHIBIT F

Camino Medical Group
BOARD OF DIRECTORS MEETING
November 8, 2005

Present: Drs. Aigen, Brosterhous, Kristensen, Slavin, Strichartz, Tai and Vilardo

TOPIC	DISCUSSION	ACTION
CMG, Inc. PSA	Dr. Slavin presented the financial estimates for the PSA for 2005. Through October 31st, there is a $24M PSA deferral payable to CMG. In addition the existing Camino Division of PAMF obligation to CMG of $10M was reviewed. This was the amount of accounts receivable that was outstanding at the time of the Camino Medical Group affiliation agreement with PAMF in June of 2000. The potential increase in malpractice liability due to growth in # of MDs and specialty coverage in the group was acknowledged. The Board also discussed the ever increasing need for retained earnings to fund building space and equipment to accommodate and support this increased growth. In light of these discussions, Dr. Slavin suggested that the Board take the following actions: 1. Increase the Malpractice Risk Retention Fund by $5M 2. Forgive the PAMF obligation to pay CMG the $10M collected on its Accounts Receivable from June 2000 3. Forgive the PAMF obligation to pay CMG $18M of its deferred PSA obligation	The Board approved this suggestion.
CMG Balance Sheet	Discussion of a CMG Balance Sheet was led by Dr. Slavin including the impact of forgiving the original AR.	No Board action was taken.
December Board Meeting	Dr. Aigen indicated that the December 13th Board meeting needed to be changed to accommodate the Compensation Committee's final distribution recommendations. The meeting will be changed to Wednesday, the 14th from 12:30 to 1:30 in Dr. Slavin's office where lunch will be provided. There will be no Board of Directors meeting on December 13th.	No Board action was taken.
New Building Atrium	Dr. Slavin led a discussion regarding the need for additional fire protection in the new building and the architect's solution of placing a fire door between the first and second floor in the atrium.	No Board action was taken.
ECH Relationship	Discussion was led by Dr. Aigen and Dr. Slavin regarding the El Camino Hospital plans for primary care clinics and also the Camino and El Camino plans for a Cancer Care clinic and the potential for a possible integrated Radiation Oncology service.	No Board action was taken.
Palo Alto Medical Foundation Integration	Dr. Aigen and Dr. Slavin led a discussion regarding the presentation by Tony Marzoni to the Palo Alto Medical Clinic physicians regarding integration of the Palo Alto Medical Foundation.	No Board action was taken.
Aexcel Specialist Evaluation Process	Dr. Slavin led a discussion regarding Aetna's healthcare plan for pay for performance for specialists. A long Board discussion ensued about opportunities for improving specialist care and performance.	No Board action was taken.

Respectfully submitted,

Torben Kristensen, M.D.
Secretary, Board of Directors

EXHIBIT F

§448(d)(3)

CAMINO MEDICAL GROUP

MEMORANDUM

To: Richard DeFronzo

From: David McCanna
Controller

Date: September 14, 2005

Re: **Camino Medical Group, Inc Corporate Tax Return Information**

Enclosed please find materials related to the Camino Medical Group, Inc corporate tax return engagement that we have been discussing. Now that our 2004 returns are completed, we feel it appropriate to sign the engagement letter for future work with your firm. As mentioned in my e-mail to you yesterday, we have a significant potential tax issue that has arisen for 2005 due to the restructuring of the compensation arrangement for physician services.

I have enclosed the Affiliation Agreement with Sutter Health that describes the relationship between the various parties, as well as the existing Professional Services Agreement (PSA). The PSA is being revised effective October 1, 2005, however certain funds have been accrued and not paid under the existing arrangement. At December, 2004, there was an accrued receivable from Palo Alto Medical Foundation in the amount of approximately $42 million. Of that, about $11 million related to the opening patient accounts receivable balance at the affiliation date of June 1, 2000, as referenced on page 19 of the Affiliation Agreement paragraph 3.6(c)5. An additional $22 million has been accrued but not received per the Deferred Compensation Agreement attachment to the PSA. The remaining $9 million represents normal cash float for about one month of receipts due.

The disposition of the $11 million and $22 million portions needs to be addressed before the end of the year and the structure of the change could trigger tax consequences. We would like to review this in detail next week either via an on site meeting with our CEO, or via conference call.

Please contact me at 408-523-3819 should you have any questions or need additional documentation. We look forward to our relationship with you and your firm going forward.

EXHIBIT G

Sutter Health

Finance Department

MEMORANDUM

DATE: December 8, 2005

TO: Colette Boudreau
Ernst & Young
Internal Audit
PAMF-Camino Division Quarterly File – Financial Reporting

FROM: Shelly Boehm, Sutter Health Asst. Controller/Director of Financial Ops.

SUBJECT: PAMF – Camino Division PSA deferred comp forgiveness

Background

The affiliation agreement from June of 2000, provided that Camino Medical Group (CMG) retain ownership of the group's patient receivables in existence at the time of affiliation. However, PAMF-Camino Division (CD) was tasked with collecting these receivables. Approximately $10M of the collected receivables owed to CMG after the date of affiliation has been held as a liability of PAMF (CD) per a stipulation that provided that if a certain level of integration had been achieved, CMG would forgive the obligation.

At the time of Camino's affiliation, a "Deferred Compensation Agreement" between (CMG) and PAMF (CD) existed that provided for an accrual of compensation by PAMF-Camino Division to CMG to be paid when later billed. Since the affiliation in 2000, this liability has been growing on the books of PAMF (CD.) The deferred comp payable balance as of September 30, 2005 was approximately $23M.

Recent Activity

An amended Camino Medical Group PSA was adopted effective October 1, 2005 that excluded any Deferred Compensation Agreement. The PSA specifies when the Group shall be paid all compensation. Therefore, the Medical Group needed to decide whether to be paid or forgive the amounts noted above. The Executive Board of the Group with the full backing of its shareholders has decided to forgive the entire approximately $33M liability.

The PAMF Board has elected to designate and transfer $5M of existing cash to the Camino Division's Professional Liability Fund that already has approximately $10M in Board designated funds.

EXHIBIT H

The PAMF Board has elected to designate $28M of existing cash and create a separate investment account for a Camino Division Capital Projects fund. It is anticipated that these funds would be used to supplement philanthropic gifts and future earnings to offset the need for additional debt financing on facility expansion in Sunnyvale and/or Cupertino (with appropriate approvals by PAMF finance committee & Board as well as Sutter Health.)

Action

PAMF (CD) is planning to book the liability forgiveness as follows in their November financial statements:

Dr.	Payable to Group	$33M	
Cr.	Other operating revenue		$10M (for Group A/R collections)
Cr.	Physician compensation expense		$23M

PAMF (CD) is planning to show the Board designation as the cash is moved in December. The exact PAMF division that will hold the asset could be other than PAMF (CD.)

Dr.	AWUIL investment	$ 5M (Professional Liability Fund)	
Dr.	AWUIL investment	$28M (Capital Projects Fund)	
Cr.	Cash		$33M

Affiliate has requested validation of accounting treatment. Sutter Health Finance would like E&Y validation.

EXHIBIT H

THOMAS L. DRISCOLL
ATTORNEY AT LAW

MEMORANDUM

TO: Kate Heinemann

FROM: Tom Driscoll

CC: David McCanna

DATE: March 19, 2009

RE: CMG Audit

I. INTRODUCTION

In response to the February 26, 2009 Information Document Request from the IRS, I reviewed with CMG executives and accounting personnel the history of the accounting and tax treatment of the approximately $10 million of pre-June 1, 2000, CMG accounts receivable ("Old A/R") and specifically explored what written instruments, if any, were available to document the treatment accorded the Old A/R. Here is what I learned:

In negotiating the Affiliation Agreement (the "Agreement") in the spring of 2000, there was an ongoing concern about the availability of cash for operations in the months immediately following the effective date of the Agreement,[1] as well as the availability of capital for the development of various medical facilities that the parties anticipated would be required for a successful business operation going forward. One the upshots of these discussions was the drafting of the Deferred Compensation Agreement, previously furnished to the IRS, with explanation. Under its terms, an amount (equal to the difference between the amount earned by CMG and the amount required to pay expenses of CMG) would be withheld by PAMF from payment to CMG pending certain occurrences.

Another provision of the Agreement required that PAMF would collect the Old A/R on behalf of CMG, retain a collection fee, and pay over the balance to CMG.[2] This in fact was done. As CMG's enclosed records (the "Deferral Schedule") show, these amounts were paid down by September 2000.

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[1] June 1, 2000.

[2] Exhibit 1.2 of Agreement.

EXHIBIT I

II. EXPLANATION OF ACCOUNTS RECEIVABLE

The December 8, 2005 memorandum from the Sutter Health Finance Department to Ernst & Young, states that "(a)pproximately $10 million of collected receivables owed to CMG after the date of the affiliation has been held as a liability of PAMF (CD) per a stipulation that provided that if a certain level of integration had been achieved, CMG would forgive the obligation." The quoted language, from the perspective of CMG, is only partially correct.

First, there was indeed a stipulation, but not in writing. Around the time of the effective date of the Agreement, Dr. Richard Slavin, CEO of CMG, and Dr. David Druker, CEO of PAMF, discussed their concerns regarding the availability of future capital for the integrated medical enterprise. Drs. Slavin and Druker, who are professional colleagues and personal friends for many years, agreed, with the concurrence of their boards of directors, that the Old A/R would indeed be collected and paid over to CMG, as described above (the "Oral Agreement"). However, the Oral Agreement also provided that an equivalent amount of compensation – that would otherwise become payable to CMG on account of the work it performed for PAMF pursuant to the PSA – would be withheld from CMG. Like the amounts withheld under the Deferred Compensation Agreement, amounts deferred pursuant to the Oral Agreement would be paid to CMG, if at all, only upon termination of the PSA relationship. And, like the amounts withheld under the Deferred Compensation Agreement, CMG would relinquish any contingent rights to those funds if and when an integration decision was made.

As demonstrated in the Deferral Schedule, CMG maintained an accurate record of the collections of the Old A/R, $10,179,648, until they were paid in full in September 2000. CMG then maintained a separate "tracking" account in which ongoing accruals of newly generated PAMF deferred accounts receivable were recorded. The Deferral Schedule indicates that by November 2000, the amount of deferred compensation held back by PAMF was $10,692,204, an amount greater than Old A/R. The amount of deferred compensation tracked in the Deferral Schedule never drops below $10,179,648 after November 2000. This first tranche of the deferred compensation represented the amount of deferred compensation retained by PAMF pursuant to the Oral Agreement. This amount stayed on the books until November and December 2005 when, pursuant to the stipulation, CMG relinquished its contingent rights to that sum, along with the amounts due pursuant to the Deferred Compensation Agreement, the total amount of deferred compensation being $34,200,000.

CMG management confirmed that they saw no practical distinction between the amounts withheld by PAMF under either approach.[3] Both sums would be available to CMG only if CMG elected to terminate the PSA and sever its relationship with PAMF.

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[3] The fact that the Deferral Schedule also makes no distinction between the amount of deferred compensation held pursuant to the Deferred Compensation Agreement and the amount held pursuant to the Oral Agreement, further confirms that CMG did not distinguish between the two amounts.

III. RELEASE OF UNVESTED RIGHTS TO DEFERRED INCOME

When in 2005, PAMF asked CMG to relinquish any rights to both sums of deferred compensation, the CMG Board recognized that such relinquishment was made pursuant to the Deferred Compensation Agreement and the Oral Agreement.[4] CMG sent a memo to its then-tax accountant identifying the proposed transaction.[5]

In reviewing these transactions, CMG management, which was involved in negotiating the 2005 PSA amendment and the 2006 PSA (in order for PAMF to comply with Rev Proc 97-13 tax-exempt financing requirements), confirmed that CMG was not represented by counsel in these transactions. From CMG's perspective, each side simply agreed to the treatment, and carried it out on their books. PAMF confirmed the treatment to its outside auditors; CMG brought it to the attention of its outside tax accountants.

IV. LEGAL ANALYSIS

Under the Deferred Compensation Agreement and the Oral Agreement, CMG never had constructive receipt of the $34.2 million that was held by PAMF and, ultimately, kept by PAMF pursuant to the terms of the two agreements.

The doctrine of constructive receipt provides that a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another.[6] Regarding constructive receipt, Treasury Regulation Section 1.451-2(a) provides:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.

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[4] See Minutes from CMG Board of Directors Meeting November 8, 2005: "Dr. Slavin presented the financial estimates for the PSA for 2005. Through October 31st, there is a $24M PSA deferral payable to CMG. In addition the existing Camino Division of PAMF obligation to CMG of $10M was reviewed. This was the amount of accounts receivable that was outstanding at the time of the Camino Medical Group affiliation agreement with PAMF in June 2000....Dr. Slavin suggested that the Board take the following actions...Forgive the PAMF obligation to pay CMG the $10M collected on its Accounts Receivable from June 2000."

[5] Letter to Richard DeFronzo from David McCanna dated September 14, 2005.

[6] Rev. Rul. 60-31

For example, in *North Am. Oil Consolidated v. Burnet*,[7] the Supreme Court ruled that a company was not required to report as income an amount which it might never receive. The Court explained that there was "no constructive receipt of the profits...because at no time during the year was there a right in the company to demand that the receiver pay over the money."[8]

CMG did not have constructive receipt of the $32.4 million between the time it entered into the PSA and the time such amounts were recorded and maintained by PAMF pursuant to the terms of the deferred compensation agreements. First, Section 2 of the Deferred Compensation Agreement specifically designates the difference between the amounts earned by the CMG doctors under the PSA and the amounts actually paid by PAMF to CMG as deferred compensation. The amount "earned" under the PSA represented compensation paid to the doctors and was set by a predetermined formula contained in the PSA.[9]

Second, the Deferral Schedule confirms the fact that the amount of deferred compensation was subject to substantial limitations or restrictions. In each column of the Deferral Schedule, the amount denominated DEFERRED COMPENSATION (line 17) is equal to the difference between the total amount of compensation paid to the doctors under the PSA (line 1) (as well as other amounts necessary to function as the Camino Division (lines 3-10)) and the amount actually paid over to CMG by PAMF (lines 14 and 15). This deferred compensation amount accrued throughout the five years of the PSA under the terms of the Deferred Compensation Agreement and the Oral Agreement. CMG was not legally entitled to it, and it was not included in CMG's earnings. Only in November and December of 2005 is it clear that the right to receive the deferred compensation will not be triggered.

The amount of deferred compensation on the Deferral Schedule was held by PAMF in a general fund and subject to PAMF's general creditors. As such, PAMF's obligation to pay CMG the deferred compensation upon the termination of the affiliation amounted to no more that "an employer's mere promise to pay funds, not represented by notes or otherwise secured, [and] cannot constitute constructive receipt by the employee to whom the promise was made." Rev. Rul. 60-31, 1960-1 C.B. 174, 177.

The amount of deferred compensation reflected in the Deferral Schedule is not segregated into amounts allocable to the Deferred Compensation Agreement and the Oral Agreement. This indicates that both CMG and PAMF considered the deferred compensation as a single uniform amount. The substance of both deferred compensation agreements was that certain unsecured amounts would be held by PAMF for CMG's benefit but subject to contractual restrictions. Only when a certain contractual provision of the Agreement was met – the five year benchmark of affiliation– did CMG give up an unvested right to the deferred compensation held pursuant to the

[7] 286 U.S. 417, 423 (1932).

[8] *Id.*

[9] Attachment B to the PSA.

EXHIBIT I

Deferred Compensation Agreement.[10] Similarly, the Oral Agreement contemplated that additional amounts of deferred compensation equal to the Old A/R would be held for CMG, and, if the two entities were further integrated, such amounts would be retained by PAMF.

Thus, the language and intent of the Agreement, when read in conjunction with both the Deferred Compensation Agreement and the Oral Agreement, indicate that both CMG and PAMF agreed that certain amounts would be recorded and subject to substantial limitations and restrictions. CMG would have no access to these unsecured funds and only upon the occurrence of other contractual provisions (i.e. the termination of the affiliation) would CMG be entitled to access the money held by PAMF.[11]

The requisite termination never occurred and the Deferral Schedule confirms that CMG never had access to those amounts held by PAMF.

Thomas L. Driscoll, Attorney at Law
2002 Third Street, #114
San Francisco, CA 94107
415/281-0900 (direct)
415/281-0903 (fax) / 415/999-3507 (cell)
tdriscoll@tld3.com

[10] §3.6(d) of the Agreement provides that after five years from the Effective Date of the Agreement, the Capital Charge would be reduced automatically provided CMG forgave PAMF's liability to pay CMG under the Deferred Compensation Agreement.

[11] §2 of the Deferred Compensation Agreement provides that the entire deferred compensation amount shall become due and payable upon termination of the PSA.

Camino Medical Group/PAMF Deferral Schedule

	2000								
	May	June	July	Aug	Sept	Oct	Nov	Dec	Cumulative
Total Compensation under PSA		3,317,026	3,320,341	3,401,038	2,721,857	3,264,078	3,716,613	3,295,203	23,036,156
Payment of deferred amounts									
Employee Payroll		2,298,109	2,161,421	2,395,089	2,610,313	2,488,653	2,474,561	2,729,639	17,157,785
Rent		215,559	217,475	217,441	217,596	211,871	211,017	210,929	1,501,888
A/P Misc Cash Activity		26,456	(11,098)	(67,155)	(7,648)	(7,385)	(6,842)	(17,018)	(90,690)
record Unilab accrual (from PAMF)									
Outside Income Recorded in Error									
Inventory Transfer		204,500							204,500
Workers Comp.-LOC									
Pre-paid Expense Transfer		623,053							623,053
Interco auto offset correction									
Total Billings		6,684,703	5,688,139	5,946,413	5,542,116	5,957,217	6,395,349	6,218,753	42,432,692
Payments by PAMF (wire transfers)		(1,134,501)	(3,203,064)	(3,582,424)	(5,923,255)	(7,684,878)	(3,993,613)	(6,376,779)	(31,898,514)
Payments by PAMF (AP check for PSA)									
Sub-total Net Amount Outstanding = DEFERRED COMPENSATION		5,550,202	2,485,075	2,363,989	(381,137)	(1,727,661)	2,401,736	(158,026)	10,534,178
Collection of A/R from Before PSA									
A/R balance to CMG	10,179,648								10,179,648
Payments toward A/R balance		(4,065,405)	(2,983,734)	(2,318,710)	(811,799)				(10,179,648)

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Camino Medical Group/PAMF Deferral Schedule

	2001													*Cumulative*
	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Cumulative	Through 2001
Total Compensation under PSA	3,973,739	3,996,884	4,223,698	4,064,261	4,203,997	3,899,395	3,787,766	4,585,688	3,533,810	4,312,288	3,567,787	3,125,540	47,274,853	70,311,009
Payment of deferred amounts														-
Employee Payroll	2,724,350	2,489,805	2,854,711	2,574,241	2,770,525	2,736,160	2,751,819	2,765,618	2,780,138	3,072,537	2,943,047	3,178,147	33,641,098	50,798,883
Rent	207,768	207,673	207,538	207,369	207,364	207,371	203,618	203,626	203,555	203,553	203,554	203,563	2,466,550	3,968,438
A/P Misc Cash Activity	(7,411)	(4,296)	(2,039)	7,967	6,792	13,579	(315,101)	93,569	149,313	158,495	104,872	3,339	209,080	118,390
record Unilab accrual (from PAMF)														-
Outside Income Recorded in Error														-
Inventory Transfer													-	204,500
Workers Comp.-LOC														-
Pre-paid Expense Transfer													-	623,053
Interco auto offset correction														-
Total Billings	6,898,444	6,690,066	7,283,908	6,853,838	7,188,678	6,856,505	6,428,102	7,648,501	6,666,816	7,746,873	6,819,260	6,510,589	83,591,581	126,024,273
Payments by PAMF (wire transfers)	(5,581,781)	(5,150,000)	(4,955,000)	(8,400,000)	(5,900,000)	(5,650,000)	(6,900,000)	(6,900,000)	(5,350,000)	(9,700,000)	(5,250,000)	(9,200,000)	(78,936,781)	(110,835,295)
Payments by PAMF (AP check for PSA)														
Sub-total Net Amount Outstanding = DEFERRED COMPENSATION	1,316,663	1,540,066	2,328,908	(1,546,162)	1,288,678	1,206,505	(471,898)	748,501	1,316,816	(1,953,127)	1,569,260	(2,689,411)	4,654,800	15,188,978
A/R balance to CMG														
Payments toward A/R balance														

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EXHIBIT I

Camino Medical Group/PAMF Deferral Schedule

	2002													*Cumulative*
	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Cumulative	Through 2002
Total Compensation under PSA	4,960,521	4,802,441	4,815,869	5,336,912	5,142,626	4,906,709	6,522,182	3,732,931	4,204,778	5,707,470	4,324,507	4,747,578	59,204,524	129,515,533
Payment of deferred amounts													-	-
Employee Payroll	3,220,445	2,918,876	3,184,518	3,026,725	3,235,918	3,055,544	3,227,030	3,233,124	3,018,521	3,383,410	3,277,599	3,213,343	37,995,053	88,793,936
Rent	152,319	151,380	147,048	146,913	146,610	145,838	145,733	145,093	139,942	140,249	134,150	82,093	1,677,368	5,645,806
A/P Misc Cash Activity	70,490	161,124	12,001	33,266	(20)	34,026			5,145	44,088		(1,034)	359,086	477,476
record Unilab accrual (from PAMF)													-	-
Outside Income Recorded in Error													-	-
Inventory Transfer													-	204,500
Workers Comp.-LOC													-	-
Pre-paid Expense Transfer	-												-	623,053
Interco auto offset correction													-	-
Total Billings	8,403,775	8,033,821	8,159,436	8,543,816	8,525,134	8,142,117	9,894,945	7,111,148	7,368,386	9,275,217	7,736,256	8,041,980	99,236,031	225,260,304
Payments by PAMF (wire transfers)	(7,300,000)	(7,500,000)	(4,700,000)	(11,150,000)	(6,100,000)	(6,150,000)	(7,900,000)	(6,500,000)	(7,600,000)	(10,000,000)	(5,500,000)	(13,675,000)	(94,075,000)	(204,910,295)
Payments by PAMF (AP check for PSA)														
Sub-total Net Amount Outstanding = DEFERRED COMPENSATION	1,103,775	533,821	3,459,436	(2,606,184)	2,425,134	1,992,117	1,994,945	611,148	(231,614)	(724,783)	2,236,256	(5,633,020)	5,161,031	20,350,008.35
A/R balance to CMG														
Payments toward A/R balance														

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EXHIBIT I

Camino Medical Group/PAMF Deferral Schedule

	2005									*Cumulative*	*Cumulative*
	Jan	Feb	March	April	May	June	July	Aug	Sept	Jan 05–Sept 05	Through Sept 05
Total Compensation under PSA	6,125,610	6,905,185	9,281,920	7,587,045	7,632,870	9,353,171	7,874,042	11,574,980	9,240,473	75,575,296	364,979,007
Payment of deferred amounts										-	-
Employee Payroll	4,564,063	3,948,435	4,556,455	4,556,455	3,816,283	4,116,871	4,181,445	4,559,052	4,446,615	38,745,674	218,146,187
Rent	4,290	4,290	2,090	2,090	2,090	-				14,851	6,598,940
A/P Misc Cash Activity	-	30								30	474,559
record Unilab accrual (from PAMF)									13,990	13,990	13,990
Outside Income Recorded in Error	(94)		(5,956)	(297)				458	500	(5,389)	(9,272)
Inventory Transfer										-	204,500
Workers Comp.-LOC			(1,989)			(2,883)				(4,871)	(1,981)
Pre-paid Expense Transfer										-	623,053
Interco auto offset correction	29,580	(29,580)								-	-
Total Billings	10,693,869	10,828,360	13,832,521	12,145,293	11,451,243	13,467,159	12,055,487	16,134,490	13,701,578	114,310,000	590,999,402
											-
Payments by PAMF (wire transfers)	(12,000,000)	(9,000,000)	(12,000,000)	(14,500,000)	(8,000,000)	(9,000,000)	(14,000,000)	(8,000,000)	(19,000,000)	(105,500,000)	(540,132,843)
Payments by PAMF (AP check for PSA)											-
Sub-total Net Amount Outstanding = DEFERRED COMPENSATION	(1,306,131)	1,828,360	1,832,521	(2,354,707)	3,451,243	4,467,159	(1,944,513)	8,134,490	(5,298,422)	8,810,000	50,866,559
A/R balance to CMG											
Payments toward A/R balance											

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Camino Medical Group/PAMF Deferral Schedule

	2005/2006								Cumulative	Cumulative
	NEW PSA	Oct 2005	Nov 2005	Dec 2005	NEW PSA	Jan 2006	Feb 2006	March 2006	Oct 05–March 06	Through March 2006
Total Compensation under PSA		8,315,290	8,379,193	8,152,521					24,847,004	389,826,011
Payment of deferred amounts			(33,000,000)	(1,200,000)					(34,200,000)	(34,200,000)
Employee Payroll		4,303,209	4,382,203	4,451,798		4,427,505	3,765,127	4,613,727	25,943,569	244,089,756
Rent									-	6,598,940
A/P Misc Cash Activity									-	474,559
record Unilab accrual (from PAMF)									-	13,990
Outside Income Recorded In Error									-	(9,272)
Inventory Transfer									-	204,500
Workers Comp.-LOC									-	(1,981)
Pre-paid Expense Transfer									-	623,053
Interco auto offset correction									-	-
Total Billings		12,618,499	(20,238,604)	11,404,319		4,427,505	3,765,127	4,613,727	16,590,573	607,619,555
Payments by PAMF (wire transfers)		(15,000,000)	(3,100,000)	(6,836,686)		(5,375,824)	(4,000,000)	(6,500,000)	(40,812,510)	(580,945,353)
Payments by PAMF (AP check for PSA)			(7,704,334)	(7,704,334)		(7,704,334)		(1,734,002)	(24,847,004)	(24,847,004)
Sub-total Net Amount Outstanding = DEFERRED COMPENSATION		(2,381,501)	(31,042,938)	(3,136,701)		(8,652,653)	(234,873)	(3,620,275)	(49,068,941)	**1,827,198.42***
A/R balance to CMG										
Payments toward A/R balance										

* The remaining balance of $1,827,198.42 represents PAMF employee payroll accruals for 2006.

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EXHIBIT I

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SAN FRANCISCO, CA 94111-3601
TEL 415.834.1800 FAX 415.834.1888
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October 12, 2010

VIA U.S. CERTIFIED MAIL
RETURN RECEIPT REQUESTED

Salenshni D. Anand
MS F360
Franchise Tax Board
P.O. Box 1468
Sacramento, CA 95812-1468

Re: Camino Medical Group, Inc.
Taxable Years: 2005, 2006 and 2007

Dear Ms. Anand:

This letter is in response to your correspondence dated August 18, 2010. I am enclosing a copy of the Internal Revenue Service (IRS) Report (Form 4549-A Income Tax Discrepancy Adjustments and Form 886-A Explanations of Items) and Form 870 Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment, as you requested.

The last paragraph of the IRS Report, page 9 of Form 886-A, states, "All adjustments to Camino Medical Group's income tax liability are for federal income tax purposes only." Accordingly, please take notice that the report does not limit Camino Medical Group, Inc.'s (CMG) ability to challenge any proposed assessment by the Franchise Tax Board and/or the grounds on which a Franchise Tax Board notice is based.

CMG resolved its audit examination with the IRS through a settlement. Both parties were fully aware and expected that the compromise would place the taxpayer in a position where no tax would be due and owing.

For purposes of settling the aforementioned audit, the amount of $10,179,648 was characterized as having been constructively received in tax year 2005. This amount was deferred compensation that accrued in tax year 2000. The settlement also included an offsetting deduction for the purchase of an intangible contract, which was amortized with a net operating loss being carried back to 2005 resulting in a full offsetting deduction in the tax year 2005.

Pursuant to California Revenue and Taxation Code Section 18622(a), the taxpayer maintains that the IRS's Report is erroneous for the following reasons:

EXHIBIT J

1. CMG is a cash basis taxpayer. It never had actual receipt of the $10,179,648 amount in issue in any year.

2. CMG never constructively received the amount in issue. The taxpayer did not have constructive receipt as a result of an oral agreement entered into in tax year 2000 (before the income was available to the taxpayer) to withhold compensation under a Personal Services Agreement between CMG and Palo Alto Medical Foundation and to forgo the balance due unless the affiliation between the two entities was unsuccessful. In tax year 2005, the two entities formalized their oral agreement by creating a written amendment to the Personal Services Agreement in order to extinguish the contingent payment obligation and to lock in what the taxpayer believed would be a future increased income stream. The restructuring of the Personal Services Agreement did not require CMG to recognize the amount in issue as income in tax year 2005 under the doctrine of constructive receipt.

3. If the constructive receipt doctrine applies to the $10,179,648, which the taxpayer disputes, then the amount would be reportable in income in tax year 2000.

Finally, I am also enclosing copies of Forms 3520 Power of Attorney on behalf of Richard Blake and Tom Driscoll, in addition to my law firm. Please contact me at 415-834-0117 should you have any question regarding this letter.

Kind regards,

WOOD & PORTER

David B. Porter

David B. Porter

DBP:rit
ZA663.3

cc: Palo Alto Medical Foundation
Richard Blake
Tom Driscoll
Robert W. Wood

EXHIBIT J

Fax Confirmation Report

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HS:Host Send	PL:Polled Local	EC:Error Correct	TS:Terminated by System
HR:Host Receive	PR:Polled Remote	MP:Mailbox Print	RP:Report
WS:Waiting Send	MS:Mailbox Save	TU:Terminated by User	G3:Group3

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Wood LLP
ATTORNEYS AT LAW

333 Sacramento Street
San Francisco, CA 94111-3601
Tel. 415.834.1800 Fax 415.834.1888
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Canadian Bar Association Australian Bar Council

Date: January 17, 2012

Name: Mr. Blake Cunningham

Company: Protest Unit, State of California Franchise Tax Board

Phone:

Fax: 1-916-843-0168

From: Christopher A. Karachale

Re: 392:BEC:F380, Additional Information related to Camino Medical Group's Shadow Fund

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There are 28 pages including this fax cover sheet. If there are any problems receiving this fax, please contact Wood LLP at 415-834-1800.