Legacy DMC

June 9, 2016

Mr. William R. Bloomfield
Michigan Department of Attorney General
Corporate Oversight Division
Charitable Trust Attorney

Dear Mr. Bloomfield:

The purpose of this letter is to provide Legacy DMC's fifth annual report covering VHS of Michigan's compliance with respect to certain Post-Closing Covenants contained in the Purchase and Sales Agreement (PSA) among the Department of Attorney General, Legacy DMC, VHS of Michigan, Inc. and Vanguard Health Systems, Inc. Legacy DMC is required to report annually on the status of these commitments by Article 3 (Item E) of the Monitoring and Compliance Agreement among the same four parties.

Article 12 of the PSA, Post-Closing Covenants of Buyer, established 20 Post-Closing Covenants, which are provided for reference in Attachment 1 (Tab 2). A list of these Covenants along with the related reporting and monitoring responsibilities is provided in Attachment 2 (Tab 3). As shown by underline, VHS of Michigan (VHS) is required to report to Legacy DMC (Legacy) annually on 15 of the 20 Covenants.

The annual VHS Report provides information regarding the status at the end of 2015 for each of the 15 covenants for which status reporting was required. Note that Legacy is required to monitor seven of the Covenants – all of which are included in the VHS Report.

During 2013, Tenet Healthcare Corp. (Tenet), a Dallas-based company, purchased Vanguard Health Systems, Inc. including its subsidiary VHS of Michigan. Tenet has acknowledged its obligation to fulfill the commitments established in the PSA as conditions of the sale of the Detroit Medical Center.

SUMMARY OF COMPLIANCE MONITORING

Legacy has established quarterly reviews relating to four critical Covenants: the two capital spending commitments, the indigent care commitment, and the commitment to maintain the six hospitals and their key lines of service. Information relating to these four commitments is reviewed by Legacy's Board of Trustees as soon as practicable, usually two months after each quarter-end. Related matters are also reviewed at these meetings. In 2015, these discussions focused on the likely violations of the Capital Expenditures Covenant. Information on the other commitments (research, education, health and wellness initiatives, etc.) is provided by VHS in its annual report and reviewed then.

Orchestra Place • 3663 Woodward Ave. • 5th Floor • Detroit, MI 48201-2400 • (313) 578-2311 • FAX (313) 578-2464

VHS submitted its 2015 Report on February 29, as required. The VHS Report (Tab 8) provides updates on all commitments and includes nine Exhibits. Exhibit B reports the $3.9 million shortfall to the $350 million commitment for Routine Capital Expenditures, and Exhibit D contains Tenet's letter advising that it will not make an $80.5 million deposit to an escrow account established for this purpose. Both these items are discussed more fully later in this report.

Legacy believes that Tenet's 2015 Report identifies two violations of the PSA Covenants. Specific observations on the monitored Covenants are provided below and on the following pages. Attachment 3 (Tab 4 - *Fifth Year Status Summary*) provides a summary of the compliance situation. It identifies the following issues: the escrow issue, the shortfall to the Routine Capital Expenditures Commitment, the delayed completion of the Children's Hospital Tower to December 2017, and the risk of significant declines in capital expenditures in the future.

<u>INDIGENT AND LOW INCOME CARE</u>

The VHS Report states that Tenet has continued the "more benevolent" charity care policy established in 2011 at the time of the Vanguard purchase. DMC's executives have confirmed this at meetings with Legacy's Board.

Legacy reviews financial statement expense data relating to charity care and bad debt each quarter. The VHS Report included 2015 expense data that is consistent with these quarterly reviews (Exhibit A). These expenses decreased dramatically in April 2014 as a result of the combined effects of the Affordable Care Act and the state of Michigan's expansion of Medicaid eligibility and remain significantly below levels experienced in 2011, 2012 and 2013.

The VHS Report refers to its successful efforts to identify and enroll patients in these programs in the discussion of Health and Wellness Initiatives on pages 9 and 10 and Exhibit I. Tenet has classified the charity care and bad debt expense information in the VHS Report as confidential.

The VHS Report mentions that the significant reduction in the cost of uncompensated care must be balanced "in 2015 and over time" with reductions in other federal and state payment programs directly beneficial to the DMC.

Legacy operates a telephone hotline and email and postal addresses to obtain patient complaints relating to indigent care; it also reviews DMC's ombudsman records to identify issues associated with the charity care policy. There were no actionable complaints in 2015.

Legacy believes that the DMC hospitals continue to provide patient treatment that is consistent with the charitable care policy that was implemented in January 2011 and that this key commitment has been met.

HOSPITALS AND CORE SERVICES

The VHS Report for 2015 confirms that the six hospitals referenced in the PSA and their lines of service have been maintained. It provides information on the event that led to the "cessation of services" at the Detroit Surgery Hospital located in Madison Heights. Legacy agrees that this key commitment has been met. Attachment 4 (Tab 5) provides the list of hospitals and services.

CAPITAL EXPENDITURES

VHS reported capital expenditures of $60 million in 2015 for the Specified Capital Projects. Cumulative expenditures for the Specified Projects total $419.5 million at the end of 2015. This amount was $80.5 million below the $500 million expenditure commitment and, as a result, a deposit to the escrow account in that amount was required.

The VHS Report provides information on three Specified Capital Projects completed in 2015: Huron Valley's ICU, Sinai Grace's ICU, facade and lobby, and the "unified" lobby at Harper. All of the Specified Capital Projects are now "substantially complete" except the Children's Hospital Tower. It is scheduled to be completed in December 2017 (the latest deadline provided in the PSA).

VHS forecasts that total expenditures on the Specified Capital Projects will exceed its $500 million commitment, and project expenditures to date support this forecast (see Exhibits B and C in the VHS Report).

The VHS Report includes a copy of its December 23rd letter (Exhibit D) informing Legacy of its decision not to transfer $80.5 million to the escrow account established for this purpose. Tenet concluded that a reduction to a DSH subsidy to Children's Hospital of Michigan was "discriminatory". If this were true, the PSA provides for a lower escrow threshold and no escrow payment would be required. (The PSA states, in part, that if a DMC hospital experiences a disproportionate and discriminatory reduction in various federal and state payments, the escrow schedule is extended and the annual amounts are reduced.)

Legacy has reviewed the transaction cited by Tenet; the facts do not support classification as discriminatory. The adjustment in the reimbursement to Children's Hospital resulted from a normal audit process that identified previous overpayments to Children's Hospital which had to be corrected. No policies relating to the subsidy or its distribution were changed in any way. In fact, as a result of the review, payments to several other DMC hospitals were increased.

Legacy DMC considered litigation to compel Tenet to make the escrow deposit. Given the state of the construction in process, Legacy concluded that, absent a dramatic decline in financial resources, Tenet would complete the Tower project and that, during the duration of the legal process, expenditures on the Children's Hospital Tower would diminish the required escrow deposit substantially. Legacy further concluded however, as a fiduciary, that the most likely and prudent way to ensure the completion of the Tower project would be for Tenet to provide the escrow deposit as required by the PSA.

With respect to the commitment relating to Routine Capital Expenditures, VHS reported expenditures of $126.1 million in 2015 and provides detail on facility, equipment and IT expenditures at individual hospitals. Cumulative expenditures for Routine Capital totaled $346.1 million at the end of 2015. This amount falls $3.9 million below the $350 million commitment in the PSA.

It is worth noting that included within the Routine Capital expenditure amount is about $46 million spent on a new Children's Hospital facility in Troy. Although not precluded by the PSA, this expenditure was not contemplated by the DMC Board at the time of sale negotiations. The Board members expected the entire $350 million commitment would be spent to address continuing capital needs at the existing hospitals.

Legacy has expressed its concern about the risk of a shortfall to this commitment in previous annual reports because of DMC's continuing low rate of spending in this category. Tenet's effort to recover in 2015 required a budget more than double its annual expenditure rate of the first four years. Its effort to "catch-up" fell just short. The VHS Report indicates that, when the projects approved in its 2015 budget are completed, expenditures will total more than $350 million, but it provides no information on the total 2016 expenditure budget despite Legacy's repeated requests that it present this information.

As noted in last year's report, the PSA does not define a remedy for a shortfall to the Routine Capital commitment at the end of 2015. Tenet and Legacy were unable to agree on a remedy to address the expenditure shortfall, and Tenet has been unwilling to provide any information on the 2016 capital budget or actual expenditure plans beyond the statement that the unfinished 2015 projects will be completed.

Now that the Routine Capital expenditure requirement has expired, there is a real risk that Tenet's capital expenditures will fall short of the level required to sustain the progress that has been achieved and required to stay competitive (estimated at $45-to-$60 million annually). Legacy DMC will request that future capital expenditure budgets and actual expenditures be reported to Legacy as required by the provisions of the Monitoring Agreement.

An independent certified public accounting firm reviewed the capital expenditure information pursuant to the agreed upon procedures included in the PSA. Legacy was provided with a copy of the related report, which did not note any exceptions to the reported capital expenditure figures. (A copy is included in the VHS Report, but classified as confidential.)

SALE OF HOSPITALS

The VHS Report confirms that no sale has occurred.

COMMITMENT TO EDUCATION AND RESEARCH MISSIONS

The VHS Report provides a discussion and supporting information relating to its commitments to education (Exhibit F) and research (Exhibits G and H) consistent with last year. These activities are critical functions of the DMC hospitals, and they apparently continue to receive management support.

KARMANOS CANCER INSTITUTE

The VHS Report provides information on the resolution of the various legal disputes between the DMC and Karmanos and reports that "all parties have been working cooperatively in supporting the various agreements."

HEALTH AND WELLNESS INITIATIVES

The VHS Report includes information on its "Path to Health" initiative to maximize enrollment of uninsured individuals in the insurance exchanges and make them aware of the State's expansion of Medicaid. Exhibit I provides an excellent overview of the effort and outcome of the program. This year's Report did not include information on patient safety and service quality initiatives provided in the 2014 Report.

OTHER COMMITMENTS

As mentioned above, the VHS Report provides the required confirmation of compliance with several additional commitments, including the Warrant (no change), Supplier Diversity (updated with 2015 data), Project Genesis (updated with 2015 data) and Naming Conventions (no change).

CONCLUSION

Legacy DMC believes this year's report from VHS of Michigan is complete.

As discussed above, it identifies two violations of the PSA Covenants. Capital expenditures for Specified Projects were $80.5 million below the amount required to avoid an Escrow Deposit. Tenet incorrectly classified a procedural payment adjustment as being discriminatory. Notwithstanding being informed of its error, it continues to refuse to make the required deposit.

Also, for the five-year period, Routine Capital Expenditures fell short of the $350 million commitment by $3.9 million, and Legacy has continuing serious concerns about Tenet's intentions to make sufficient routine capital expenditures going forward.

All other commitments were met.

In 2016, Legacy will request continued reporting of actual capital expenditures, but, as noted, no information in this regard has been received to date.

Joe Walsh
President

R R Widgren
Richard Widgren
Chairman

Cc.

Mr. Trevor Fetter
Mr. Joseph Mullany