Legacy DMC

April 15, 2013

Ms. Katharyn Barron, Division Chief
Consumer Protection Division and
Charitable Trust Section
Department of Attorney General
State of Michigan

Dear Ms. Barron:

The purpose of this letter is to provide Legacy DMC's second annual report covering VHS of Michigan's compliance with respect to certain Post-Closing Covenants contained in the Purchase and Sales Agreement among the Department of Attorney General, Legacy DMC, VHS of Michigan, Inc. and Vanguard Health Systems, Inc. (PSA). 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 Department of Attorney General, Legacy DMC, VHS of Michigan, Inc. and Vanguard Health Systems, Inc.

Article 12 of the PSA, Post-Closing Covenants of Buyer, defined 20 Post-Closing Covenants, which are provided for reference in Attachment 1. A list of these Covenants along with the related reporting and monitoring responsibilities is provided in Attachment 2. As shown by underline, VHS of Michigan is required to report annually on 15 of the 20 Covenants. Its annual report provides information regarding the status at the end of 2012 for each of the 15 covenants for which status reporting was required. Note that Legacy DMC is required to monitor seven of the Covenants – all of which are mentioned in the VHS Report.

SUMMARY OF COMPLIANCE MONITORING

Legacy DMC 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 DMC's Board of Trustees as soon as practicable, usually two months after each quarter-end. Other compliance matters, such as the hotline process and escrow transactions are also reviewed at these meetings. Information on the other commitments (research, education, health and wellness initiatives, etc.) is provided by VHS of Michigan in its annual report.

VHS of Michigan submitted its Annual Report on March 1, as required. It reports that all commitments have been met with the exception of capital spending for routine capital. Attachment 3 provides Legacy DMC's summary of the status of the critical Covenants. Attachment 4 provides the list of the hospitals and key lines of service. Attachment 5 is VHS of Michigan, Inc.'s 2012 Annual Report.

Legacy DMC's observations on the monitored Covenants are provided below.

INDIGENT AND LOW INCOME CARE

The VHS Report for 2012 on this commitment is essentially identical to that provided in 2011. It reports the establishment and publication of the required charitable care policy in 2011 and information on its ombudsman and complaint process. Unfortunately, Vanguard Health Systems, Inc. has classified the charity care and bad debt expense information as confidential; it is not included in its report. This information and the related patient volumes were made available to Legacy DMC for the first time in 2012 (an issue addressed since last year's report); increased spending was reported. Legacy DMC continues to encourage VHS of Michigan to provide more public information on this critical commitment to ensure appropriate recognition for its historic and continuing role in providing health services to the low income and indigent.

Doctors familiar with treatment policies at Detroit Receiving Hospital and Sinai Grace Hospital have confirmed to Legacy DMC that these facilities have implemented the required charitable care policy and continue to provide services and financial support to the indigent. A VHS of Michigan executive met with the trustees to answer questions on patient volume and cost trends. Legacy DMC's hotline is in place; however, the minimal volume on the hotline continues to provide negative assurance that there have been no instances of denial of care.

Increased costs, the lack of complaints, and the statements from front-line doctors support the view that VHS of Michigan is providing patient treatment that is consistent with the charitable care policy it implemented in January 2011.

Legacy DMC is evaluating additional complaint intake approaches to address concerns that indigent patients may be unable or unwilling to utilize the current process to report problems. These may include patient surveys or outreach to agencies that service the indigent.

HOSPITALS AND CORE SERVICES

The VHS Report for 2012 on this commitment is identical to that provided in 2011. It reiterates VHS of Michigan's commitment to maintain the existing hospitals and their lines of service. This key commitment has been met.

CAPITAL EXPENDITURES

The VHS Report for 2012 reports its capital investments for Routine Capital ($63.3 million) and Specified Capital Projects ($93.9 million). Although spending in both categories increased in 2012, both continue to fall far short of PSA commitments. Legacy DMC has concerns related to both spending shortfalls as discussed on the next page.

Cumulative expenditures on the Specified Capital Projects totaled $132.2 million at the end of 2012. As provided in the PSA, Vanguard Health Systems, Inc. deposited $27.8 million (the shortfall to the $160 million cumulative expenditure requirement for this category) with the Escrow Agent.

VHS of Michigan's Report provides a brief update on each project. Four of the 15 projects are now complete and the status of the remaining 11 projects is provided. VHS of Michigan continues to confirm that total project spending will meet or exceed its $500 million commitment. It has revised the completion date for a major project (the Tower at Children's Hospital for $163 million) to August 2017. (The PSA provided for an additional two years to complete specified capital projects.)

Legacy DMC understands the initial delays associated with this spending category and notes a relatively steady increase in the quarterly spending rate, but, after two years, spending totals $137 million – less than 30% of the requirement. The delay of the Tower project also defers a substantial element of the investment into the seventh year. The combination of the slow spending pattern and the delay of the most significant investment raises the risk that this commitment will not be met within the PSA's time requirement and that unforeseen economic issues could affect Vanguard's capacity to fund the substantial remaining investment.

Spending on Routine Capital totaled $108.2 million at the end of 2012. Unlike the Specified Capital category, the PSA does not provide any remedy, such as escrow, for shortfalls in this spending commitment nor is there any specification on how these funds must be spent.

VHS of Michigan's 2012 Report provides almost no new information on this spending category; data on its budget process and average monthly spending rates has been updated, but VHS of Michigan provides no insight into its plans to recover the shortfall, which will require $241.7 million (over $80 million per year). Most information is identical to the 2011 Report (except for date references). Also, there is no pattern of spending to support use of average monthly rates to forecast spending; during 2012 reported quarterly spending ranged from a high of $33.6 million (Second Quarter) to a low of $3.7 million (Third Quarter). Quarterly forecasts of future spending have not been reliable.

Actual spending to date has mainly been for "routine equipment replacement and upgrades" (about 38%) and "information technology" (about 25%). In both 2011 and 2012, VHS of Michigan has identified "specialty clinics" as a likely area of substantial spending in this category with about $5.6 million spent so far. Legacy DMC has clarified that spending for specialty clinics will not address any facility needs of the existing hospitals. It has pointed out that support for the sale to Vanguard was based on the fact that the cash flow of the Detroit Medical Center had been insufficient to support such necessary capital expenditures (separate and in addition to the Specified Capital Projects) and many of the needs continue to exist.

For VHS to achieve the original PSA commitment of $350 million within five years will require spending $242 million in the next three years compared with the $108 million spent in the first two years since the sale. The annual average for the next three years ($81 million) will need to be 28.5% more than the 2012 expenditure ($63.3 million).

Legacy DMC believes that there is a risk that the $350 million spending commitment may not be met within the five-year compliance period and that the planned specialty clinic spending may jeopardize the improvements to existing hospital facilities anticipated when the sale was approved. If spending is not complete at the end of 2015, there is no obvious measure that ensures the required capital is ever invested.

VHS of Michigan has committed to review its plans, particularly those relating to these routine capital issues, at the Legacy DMC Board meeting in May.

As a separate matter, VHS of Michigan has advised Legacy DMC that the amounts previously reported for 2011 routine capital expenditure need to be revised (the amount was nominal). This report has incorporated the revised information; Legacy DMC will ensure that future spending reports are scrutinized with more care.

An independent certified public accounting firm reviewed the capital spending information pursuant to the agreed upon procedures included in the PSA. Legacy DMC was provided with a copy of the report, which did not note any exceptions to the capital expenditure figures. Also, VHS has agreed to inform Legacy if financial statement control deficiencies are identified during the Sarbanes – Oxley review, which will be available later in 2013.

SALE OF HOSPITALS

The VHS Report confirms that no sale has occurred.

DETROIT BASED SYSTEMS and NATIONAL SUPPORT CENTERS

VHS of Michigan's 2012 Report confirms that Detroit continues as its regional headquarters for DMC operations. It also provides information on a reorganization of its technology infrastructure, which retains Detroit as the "primary data center" and establishes San Antonio as its "secondary data center".

OTHER COMMITMENTS

As mentioned above and shown on Attachment 2, VHS of Michigan's 2012 Report provides the required status report on several additional commitments, including the Warrant (no change), Education (updated with 2012 data), Research (no 2012 information), Karmanos (no change), Health and Wellness Initiatives (updated with 2012 data), Supplier Diversity (updated with 2012 data), Project Genesis (updated with 2012 data) and Naming Conventions (no change). Legacy DMC will encourage VHS of Michigan to provide updates on its support for Research.

CONCLUSION

Since January 2013, VHS of Michigan has announced new appointments for its CEO and COO positions. In addition, it has announced that it plans to address the effects of sequestration with cost cutting actions, while assuring the public that required changes would be accomplished with full consideration of DMC's mission and commitment to the community.

In the coming year, Legacy DMC will need to establish good communications with the new executive team and understand its plans for dealing with sequestration and for meeting its capital expenditure commitments, particularly the routine category. Legacy DMC will continue to play a constructive and collaborative role, recognizing VHS of Michigan's success in Detroit is critical to the goal of meeting the PSA commitments.

Joe Walsh
President

Richard Widgren
Chairman