Legacy DMC

April 15, 2014

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 third 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, established 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 2013 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 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. Legacy DMC provided Tenet with information on VHS of Michigan's compliance status and reporting.

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. Related matters, such as the hotline, escrow transactions, and the Karmanos-DMC dispute 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.

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VHS of Michigan submitted its Annual Report on February 28, as required. The report (Attachment 5) provides excellent updates on all commitments; particularly noteworthy is that, for the first time, no escrow deposit relating to the specified capital expenditures was required. Attachment 4 provides the list of the hospitals and key lines of service.

All minimum commitments have been met at the end of year three; however, there are risks in forward years related to capital expenditures and aspects of the Karmanos commitment are in litigation (Attachment 3).

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

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

The VHS Report confirms that Tenet, the new owner of VHS of Michigan, has continued the "more benevolent" charity care policy established in 2011 as a result of the Vanguard purchase. DMC's Chief Executive Officer had previously confirmed this at the January 2014 meeting of the Legacy DMC Board of Trustees.

Legacy DMC reviews financial statement expense data relating to charity care and bad debt each quarter. VHS of Michigan's annual report includes 2013 expense data that is consistent with these quarterly reviews. These expenses increased once again from the prior year. DMC's Chief Financial Officer reviewed the charity care policy, related procedures and expense trends with the Trustees at the January meeting. Unfortunately, Tenet has classified the charity care and bad debt expense information in its annual report as confidential; it has been removed from Attachment 5. (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 patients.)

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

Increased expense and the lack of complaints (which provides only negative assurance that there have been no instances of denial of care) support the conclusion 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.

The VHS report provides a useful explanation of factors relating to the *Affordable Care Act* that are likely to affect DMC's charity care and bad debt expense experience in 2014 and beyond.

The VHS report also summarizes certain information that appeared in a recent article in *Crain's Detroit Business,* which discussed indigent care costs trends. Legacy DMC was aware of the various adjustments required to compare indigent care expense trends.

HOSPITALS AND CORE SERVICES

The VHS Report for 2013 confirms that the existing hospitals and their lines of service have been maintained. This key commitment has been met.

CAPITAL EXPENDITURES

VHS of Michigan reports capital expenditures of $142.4 million in 2013 for Specified Projects. Cumulative expenditures on the Specified Projects total $274.6 million at the end of 2013. Last year's shortfall to the $80 million annual requirement was eliminated and, for the first time, no escrow deposit was required.

The Report provides information on the three projects completed in 2013 and three more scheduled for completion in 2014. Seven of the 15 projects are now complete and seven more are scheduled to be completed by 2015. Only the Children's Hospital Tower will not be completed by the end of 2015; its completion date is now scheduled for December 2017. VHS of Michigan continues to forecast that total expenditures on these projects will meet or exceed its $500 million commitment and actual project expenditures to date support that position.

The Report provides a discussion of the reasons for delayed construction of the Children's Tower. An update to the Children's Hospital's strategy led to substantial building design changes from the original project. DMC's Chief Executive Officer and Children's Hospital representatives reviewed the revised strategy with the Legacy DMC Trustees in January. Legacy DMC expects to meet again with the DMC to review more specific information on the building changes in May. The PSA provided for additional time to complete the Children's Hospital Tower including specific escrow requirements for 2015 and 2016. It did not contemplate an extension beyond the end of 2017. There is a risk of exceeding this timeline based on the revised construction schedule.

VHS of Michigan reports capital expenditures of $49.3 million in 2013 for Routine Capital and notes that cumulative expenditures in this category ($150 million) meet the minimum threshold for the three year period ($50 million per year). To meet the commitment will now require expenditure of $100 million per year – double the average achieved in the first three years since the purchase. Unlike the Specified Capital category, the PSA does not provide a remedy, such as escrow, for failure to meet this spending commitment.

The Report provides useful information on present plans to ramp up spending in 2014 to $79.5 million in all categories: equipment replacement and upgrades, IT, facility and physical infrastructure improvements and strategic initiatives. If achieved, expenditures of $120.5 million will be required in 2015 to meet the expenditure commitment.

Legacy DMC believes that there are significant risks and serious unresolved issues with the present plan for Routine expenditures:

* expenditure plans for 2014 forecast a 60% increase in actual spending,

* the PSA does not define a remedy for an expenditure shortfall at the end of 2015,

* actual and planned routine expenditures include substantial amounts not anticipated when the PSA was negotiated, e.g., the Troy specialty clinic, and

* the PSA provides that net cost overruns on the Specified Projects can be counted in calculating total Routine expenditures at the end of 2015, but the delay of the Childrens' Hospital Tower means this amount will not be finally determined until 2017 or later.

During 2014, Legacy DMC will engage VHS of Michigan in a thorough review of these issues with the objective of realizing the full benefits for which the sale of the hospital assets and the related commitments were negotiated. A key element of this process will be a thorough review of individual hospital facility and equipment requirements and needs.

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 reported capital expenditure figures.

<u>SALE OF HOSPITALS</u>

The VHS of Michigan Report confirms that no sale has occurred.

<u>COMMITMENT TO EDUCATION AND RESEARCH MISSIONS</u>

The VHS of Michigan Report provides substantially improved discussion and supporting information relating to its commitments to education (Exhibit C) and research (Exhibit D). These activities are critical functions of the DMC hospitals and the report confirms that they continue to receive support and management attention.

<u>KARMANOS CANCER INSTITUTE</u>

The VHS of Michigan report provides information on the legal dispute between the DMC and Karmanos.

HEALTH AND WELLNESS INITIATIVES

The VHS of Michigan Report includes information on its new "Path to Health" initiative to maximize enrolment of uninsured individuals in the insurance exchanges and make them aware of the State's expansion of Medicaid. In addition, details on health fairs and clinics staged by the hospitals are provided.

OTHER COMMITMENTS

As mentioned above and shown on Attachment 2, VHS of Michigan's 2013 Report provides the required status report on several additional commitments, including the Warrant (no change), Supplier Diversity (updated with 2013 data), Project Genesis (updated with 2013 data) and Naming Conventions (no change).

CONCLUSION

Legacy DMC believes this year's report from VHS of Michigan is the most informative of the three produced so far. Capital expenditures for Specified Projects were sufficient to avoid a deposit to the Escrow Account for the first time, and Routine spending for the first three years met the minimum requirement of $150 million. All other commitments were met.

In 2014, Legacy DMC will work with VHS of Michigan to address risks relating to the deadline for completion of the Children's Hospital Tower (December 2017) and the investment required in the next two years to meet the Routine Expenditure Commitment ($200 million). Investment in individual hospital facilities and equipment will also be reviewed and additional actions suggested, if appropriate. Legacy DMC will also monitor progress on changes affecting indigent patients, changes in state and federal funding, and the outcome of the Karmanos litigation.

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