Legacy DMC

June 30, 2017

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 sixth 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 2016 for each of the 15 covenants for which status reporting is 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. Information on the other commitments (research, education, health and wellness initiatives, etc.) is provided by VHS in its annual report and reviewed then.
In 2016, Board discussions focused on the shortfall to the Routine Capital expenditures commitment, Tenet's decision not to make an escrow deposit related to the Specified Capital

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commitment, the potential impact of DMC's negotiations with the Wayne State Medical School on the Research and Education commitments, and news reports of problems with the Central Sterile Processing Unit.

VHS submitted its 2016 Report on February 28, as required. The VHS Report (Tab 8) provides updates on all commitments and includes eight Exhibits. Exhibit B confirms the $3.9 million shortfall to the $350 million commitment for Routine Capital Expenditures, and Exhibit E contains Legacy DMC's letter requesting payment of interest relating to the DMC's decision not to make an $80.5 million deposit to the escrow account established for this purpose and DMC's response. Both these items are discussed more fully later in the report.

Attachment 3 (Tab 4 - *Tenet Covenants as of 2016*) provides a summary of Legacy DMC's view of the compliance situation as well as risks that could adversely affect forward years.

INDIGENT AND LOW INCOME CARE

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 (collectively uncompensated care) each quarter. The VHS Report included 2016 expense data that is consistent with these quarterly reviews. 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 notes that the cost of indigent care declined by about $150 million annually as a result of these programs, but rose by 4% in 2016.

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 page 10 and Exhibit G. Tenet has classified the detailed 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 DMC believes that the overall effect of reimbursement changes has been significantly favorable to the DMC hospitals.

Legacy DMC 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 2016.
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.

Legacy DMC agrees with the VHS Report which identifies a risk associated with the potential for significant changes in the federal and state subsidies relating to the indigent.

HOSPITALS AND CORE SERVICES

The VHS Report for 2016 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 $75 million in 2016 for Specified Capital Projects – mainly the continuation of construction of the Children's Hospital Tower. The remaining two projects at Harper Hospital were also completed. Cumulative expenditures for the Specified Projects total $494.6 million at the end of 2016.

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

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. (It was included in the VHS Report as Exhibit D and classified as confidential.)

Legacy DMC continues its efforts to resolve two capital expenditure issues:

- With respect to Specified Capital Projects, Legacy DMC has invoiced Tenet for interest relating to the $80.5 million escrow shortfall identified and explained in last year's report. (The VHS Report includes Legacy DMC's letter and Tenet's response in its report as Exhibit E.) Tenet and Legacy DMC are in the process of negotiating this issue, but no settlement has been reached.

- With respect to Routine Capital Expenditures (i.e., capital expenditures other than those required to complete the 15 Specified Capital projects), VHS has confirmed that in 2016, these expenditures dropped dramatically.

  In previous reports, Legacy DMC expressed its concern that routine capital investments would drop to inadequate levels after the expiration of the Routine Capital Commitment. Unfortunately, that is the case.

> Legacy DMC believes that annual capital expenditures of not less than $50 to $70 million are required to preserve the facility and equipment improvements realized in the DMC's six hospitals over the last six years. It explained this concern to the DMC's new Chief Executive Officer at a recent meeting.

<u>SALE OF HOSPITALS</u>

The VHS Report confirms that no sale has occurred.

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

The VHS Report includes its annual report on Graduate Medical Education (Exhibit F). DMC executives also provided the Legacy DMC trustees with an update on its ongoing research efforts and confirmed that these activities are critical functions of the DMC hospitals. The executives also discussed the DMC's plan to be ranked among the top 15 academic medical centers.

Notwithstanding these assurances, Legacy DMC met with representatives of the Wayne State Medical School to better understand the issues. It is clear that the collaboration between the DMC and its long-time partner in these two critical areas is at risk of deterioration. News reports of "cultural differences" and the abbreviated 18-month renewal of the DMC contract with Wayne State's Medical School raise doubts about the eventual outcome. Legacy DMC believes that robust research and education activities are necessary to avoid an adverse effect on the DMC and the patients it serves and would fall short of the commitments to support the research and education missions.

<u>KARMANOS CANCER INSTITUTE</u>

The VHS Report provides an update on the 2015 Settlement Agreement and reports that both parties continue to abide by the agreement and meet the needs of the community. Legacy DMC has confirmed this status with Karmanos.

<u>HEALTH AND WELLNESS INITIATIVES</u>

The VHS Report includes information on its "Path to Health" initiative to enroll uninsured individuals in the insurance exchanges and make them aware of the State's expansion of Medicaid. Exhibit G provides an excellent overview of the program.

In August 2016, articles describing serious quality issues in the DMC's Central Sterile Processing Unit appeared in the Detroit News. Legacy DMC has met with DMC executives recently and received assurance that changes in staffing, supervision and additional investment have successfully addressed this issue.

Patient safety and quality are not separately identified commitments within the PSA, but Legacy DMC plans to monitor CMS's Star ratings (and possibly Leapfrog reports) because improvement in these quality measures will be essential for DMC's continued success. (For example, failure to correct the sterilization problem could cause the CMS to suspend its payments to the affected hospitals.)

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 2016 data), Project Genesis (see Exhibit H) and Naming Conventions (no change).

CONCLUSION

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

As noted above, the DMC hospitals have continued their long-standing record of care for the indigent and are nearing completion of a seven-year capital expenditures program that has resulted in significant upgrades to the facilities and equipment at every hospital.

This report explains Legacy DMC's concern that success to date could be at risk in the forward years. It plans to closely monitor apparent risks, which include potential adverse changes to federal and state subsidies for the indigent, inadequate capital spending on facilities and equipment, patient safety and quality issues, and progress on achieving DMC's goal to be ranked among the top 15 teaching hospitals.

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