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Thomas F. Casey
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Re: Questions Regarding the Proposed Restructured Relationship / Definitive Agreements Between Peninsula Health Care District and MPHS

Dear Mr. Casey:

The Board of Directors of the Peninsula Health Care District met last night in both open and closed session and specifically reviewed each of your questions in light of last minute negotiations pending with MPHS. They offered many responses to your questions during their open session. Your questions were appreciated and helped contribute to the dialog last night at this last public session (of seven held) before a vote on the Agreements, now scheduled for 1pm next Tuesday (the 30th). I was asked to respond to your questions, incorporating obvious "lawyer" responses on my own, while attempting to convey the "sense of the Board" on the policy level issues. Of course the actual position of the Board will not be known until a vote is taken, but the following is offered in an attempt to convey current thinking.

Your questions are as stated and the answers are in bold.

(1) Describe what it means for Mills-Peninsula to be an "affiliate" of Sutter Health. What is the legal relationship between the two entities? The Agreements indicate that Mills-Peninsula is bound to follow the "policies" of Sutter – what policies does this refer to?

Mills-Peninsula Health System is a California nonprofit public benefit corporation and is the current tenant of the District's facility under the 1985 Lease. Sutter Health, also a California nonprofit public benefit corporation, is the sole corporate member of MPHS and as such has certain reserved authority over the corporate affairs of MPHS. Many of these reserved powers are established by state law. MPHS has its own separate articles of incorporation and bylaws, its own fiduciary board which, subject to the powers reserved to Sutter Health, is responsible

for the affairs and activities of MPHS.

Sutter Health and its affiliates, including MPHS, operate under a number of standard policies, including a number of financial policies, that result in complete system financial and other integration. In the nonprofit sector provision of hospital services, this system operation reflects a typical multi-hospital system approach focused on local governing body oversight of local issues (medical staff appointment, senior management oversight, clinical / quality oversight, etc.), and operational and management systems and policies originating from the parent organization

(2) With regard to the issue of assignment, the ground lease obligates the District to consent to any entity that takes over a majority interest in MPHS in the future ---- what if the District does not wish to conduct business with the new entity, because, for example, it is "for profit"? What happens if Sutter Health defaults on the deal or goes bankrupt?

The proposed transaction would allow under limited circumstances the transfer of the leasehold to another entity as long as it was an MPHS/Sutter "related entity" or another entity meeting specific tests, e.g., a non-religious, non-profit entity with a similar financial status, as long as MPHS stays liable for the Lease if the new operator defaults.

MPHS cannot assign its interests to a religious or for-profit organization under 10.04 (C) of the Ground Lease, and under the Deed Restrictions (attached exhibit) referenced at Section 1.03 of the Master Agreement. Major default or bankruptcy provisions are extensively covered in Article V, Defaults and Remedies, of the Master Agreement. Heavily negotiated, these provisions were crafted with the assistance of the District's own real estate, bankruptcy, and bond lawyers and financial advisers with the intent of preserving the District's ability to acquire the facility and buy-out the land leasehold, upon the most favorable terms obtainable under the bankruptcy laws and Sutter bond security restrictions. These provisions took months to negotiate with the help of this legal and financial expertise in order to account for and accommodate the many scenarios projected for possible occurrence in the future and the many resulting conflicts between the parties goals in the event bankruptcy proceeding came into play, along with Sutter's Obligated Group revenue bond financing system.

(3) What are the exact terms of the Deed restrictions to be placed on the District's property? Just what can't the District use its own property for?

The exact terms are set forth in the Deed Restrictions attached to the Master Agreement (Exhibit L-1) and incorporated in the Agreement at

Section 1.03. These restrictions on District property leased by MPHS relate chiefly to dedication of the land for health care, non-profit purposes. The District's retained acreage (approximately 5 acres) is not subject to the Deed Restriction. The only restriction on the District's retained raw land is contained in Section 2.01.B which addresses potential District operations of services duplicative of MPHS hospital "core services" as listed in the Agreement or thereinafter added to the list of core services pursuant to the Agreement. (See 3.02.C and 3.02.D.8) Use of the District Medical Office Buildings to be transferred back to the District is covered in Section 2.03, which covers their general use for medical office, physician space, and potential MPHS tenancy, but the District is ultimately not prevented from some entirely different use of the properties under those provisions.

(4) What exactly will MPHS Charity Care consist of? What input and authority will the District have with regard to such Charity Care? Would the District consider making direct Charity Care services, or, in the alternative, an "in lieu of" contribution to the County for the inequitably high Charity Care services it provides, a condition of the Agreement? Finally, is it possible to obtain a copy of the MPHS Charity Care policy?

Your office should review the MPHS and Sutter Charity Care Policies since those are referenced in the Agreement. We will fax or e mail the Policies along with transmission of this Response. As with any 501(c) (3) organization, these Policies are designed to meet IRS and California mandates for exempt charitable organizations. The Agreements do not impose additional standards beyond existing Federal and State income and property tax exemption requirements. See section 3.02.E of the Master Agreement.

The District Board has met with Supervisors Hill and Church on this issue and believes it has incorporated one of the Supervisor's key goals, ensuring MPHS participation in County sponsored Charity care planning for unmet charity care needs. On its own, the District is already lending significant support to County and non-profit sector programs for the underserved. The District devotes a substantial percentage of its current discretionary income, approximately $700,000 annually, to the San Mateo County Healthy Families Initiative and funds major programs for the District's underserved population, e.g., Samaritan House. The District has worked closely in the past with Margaret Taylor and other County officials on these programs and looks forward to a continued close relationship with County Health Services.

(5) What is the cost, if any, to the District if MPHS fails to obtain the regulatory approvals necessary to construct the new hospital?

Sections 5.04 of the Construction Agreement and Section 6.02 of the Construction Ground Lease allow MPHS to terminate the Definitive Agreements if, despite requisite effort, it cannot get the necessary regulatory approvals. If that happens, Section 6.02 of the Construction Ground Lease governs (i.e., the District reimburses MPHS for existing site improvements and has the option to complete the project using MPHS' plans or develop its own).

(6) What exactly is the cost to the District at the end of the term when it must buy out the remaining interests of MPHS? What part of the payment is determined by costs? By market values? By appraised value?

The formula for end of term limited reimbursement to MPHS is set forth chiefly at Sections 7.05 and 7.02 of the Ground Lease. Generally, commencing twenty-five (25) years prior to the expiration of the initial Lease Term and during any extension of the Lease, MPHS may seek approval of District, which District may give or not in District's sole discretion, in advance of making any of the defined significant capital expenditures with useful lives that extend beyond the expiration of the Lease. The District will pay net book value for such approved assets. For capital expenditures that the District does not approve, the District shall not be obligated to reimburse MPHS. This effectively makes the District a partner in long term capital planning for the facility when it reaches the point where such planning will impact the District's status as the successor owner of the facility.

The District's real estate economic experts, The Sedway Group of San Francisco, held a public forum in Millbrae a couple of years ago on precisely this issue at which they presented their evaluation of the economic impact of this provision. The District can provide you a copy of the videotape of this presentation and any written materials presented. Since the reimbursement obligation is difficult to project, based on events and discretionary decisions by future Boards occurring over a 50 year period, Sedway used data based on the history of the current facility, and estimated that the District's end of term obligation to MPHS would be in the neighborhood of 30 to 40 million dollars (today's dollars). They also estimated that the value of the assets received by the District at the end of a 50-year term would exceed that potential obligation.

(7) Will the MPHS-supplied quarterly reports to the District include specific cost/revenue figures for core-services, including any new services?

No, specific figures for core-services or new core services will not be required for the quarterly reports. However, should such a service be subject to a closure of service proposal, then the service line finances will be subject to independent audit review, as will the entire Hospital financial operations to determine its ability to "afford" individual service line losses. (See Section 3.02.D.4.b.1, page 20 of the Master Agreement.)

(8) Is there any guarantee that the District will not be required to provide financial contribution or support to MPHS during the term of any of the Agreements?

There is no requirement that there be any District contributions to MPHS during the term of the Agreements (other than specified options, i.e., buy-out rights upon default or contingent payments.)

(9) Would the District consider foregoing the binding arbitration clauses in the Agreements in favor of non-binding arbitration (and the implicit ability to have disputed resolved by the local courts)?

Extensive negotiation of alternative dispute resolution mechanisms throughout the agreements was undertaken, including with general input from the District's County Supervisors and the State Senator on the nature of the potential arbitration panels. The District believes JAMS options will be the least likely to be biased. The Board is unlikely to re-negotiate this provision.

(10) Would the District consider providing a shorter term lease, or, in the alternative, the right for the District to take over the operation of the hospital at an amortized cost?

Both issues were extensively negotiated and discussed with public and expert consultant input over a five year period. The District is unlikely to revisit these issues at this time. The formulas for the District's "buy out" remedies (e.g, fair market value in light of termination of the Lease in the event of bankruptcy, to take one example) involved bankruptcy and bond lawyers on both sides, along with the creation of financial projection scenarios by the District's financial consultants (Hicks Consulting and the Sedway Group). District negotiators reviewed these issues and scenarios with our County Supervisors, as well as at public forums.

(11) Because the current proposed contracts would "tie the hands" of future District boards for fifty years, would the District consider re-visiting with MPHS the issue of non-core and core services? Specifically, would MPHS consider giving up its first right of refusal to take-

over any proposed "non-core service" since, by definition, the District would not be proposing to do anything that would currently compete with MPHS? Would MPHS consider allowing the District to engage in a core service, outside certain geographical areas or based on other possible limitations?

The premise to the question is that the District would prefer to retain the sole option to pursue non-core, non-competitive activities. To the contrary, members of the Board believe it would be in the better interests of the provision of healthcare services, at least conceptually, if a proposed non-core service were offered to the operator of the Medical Center and its campus prior to becoming a District undertaking. Note the need to present potential services for MPHS' consideration, viewed by your question as a limitation, is called for only in relation to the District's use of the approximately 5 acres retained for future District development. This makes sense because of the need for coordination and integration of the ultimate use of those 5 acres with the remainder of the Medical Center campus.

(12) Recognizing the District's view that it has decided to enter into contracts specifically with MPHS because of the District's view that MPHS has proven itself to be a successful operator and a good partner, nevertheless, to be entirely sure, has the District given any consideration to an RFP process to consider other proposals by other potential operators/lessees of a new District hospital?

In the year 2000 the Board decided to attempt to negotiate construction of a new facility with MPHS after the District's and MPHS' architects and engineers both concluded that retrofitting the existing facility was not economically prudent or in the best interests of the healthcare needs of the community. There were several driving factors, paramount among them was the looming 2008, and later 2013, deadline to meet seismic standards or face closure of the existing hospital. Given that MPHS held control of the property through 2015 under the existing 1985 Lease, some restraint was imposed on the ability of the District to pursue other avenues of achieving seismic compliance. Moreover, attempting to deal with any other potential operators would entail a decision to undue the merger of Peninsula and Mills facilities, which the Board has also determined was a successful and prudent development benefiting the healthcare needs of the community.

Other factors included the Board belief that it ought to see if it could arrive at a mutual agreement with its existing operator, given the successful record of operations and community support for that operator. The District had Sutter's financial and debt capacity status evaluated by its financial advisor, Gary Hicks, who provided his evaluation of Sutter at a dedicated

public forum on financing vehicles available to the District for a stand alone operation compared to Sutter's Obligated Group mechanism (again, videotape should be available covering the presentation).

Also taken into account was the knowledge that few non-profit systems or operators existed in our region, and few would have interest in the Peninsula Hospital market, and none would be able to compete with the ability of Sutter to present itself as a likely long term (50 year) operator of local facilities. As opposed to a meaningful RFP process, the more likely alternative has been (and remains if this transaction is not implemented) that the District would undertake financing and construction of a new facility on its own, entailing the use of voter approved general obligation bonds.

(13) Can you summarize all of the ongoing costs to the District if it engages in these Agreements?

The District should have no money obligations, and should not have to incur any costs to build or operate the New Facility, for at least 60 years. The District will undoubtedly incur costs to monitor MPHS as its ground tenant, similar to those incurred presently, adjusted upward for the significantly increased level of oversight.

The Board has suggested the continuation of an ongoing Board designated fund, similar to the one currently existing and maintained by the District, designed to protect the District should MPHS/Sutter fail financially in the future or decide to leave. The District has worked closely with its financial advisors to determine potential cash reserve needs to handle various "buy-out" scenarios. Throughout the United States community hospitals have simply closed, with no alternative operator existing or available to pursue continued operations. A key facet of the proposed transaction is that it is designed to enhance the District's ability to assume that role.

Potential costs to the District under the Agreements are largely contingent on specific circumstances, or are optional expenses to the District, and are not ongoing. For example, the District might have to purchase site improvements (if the project is dropped by MPHS prior to closing the deal following voter approval) to the Start Service Date), might choose to purchase MPHS' hospital plans, or might have the option to buy the New Facility (if MPHS commits a Paramount Default). The District will have to reimburse MPHS for the value of certain assets at the end of the Ground Lease term (or any other termination prior to then), as described in response to question 6 above. The District could choose to subsidize a

Core Service slated for closure by MPHS. But there are no inherent ongoing costs beyond monitoring and oversight administration.

(14) Will, and how will the election measure notify the voters of: the issue of possible renewal of the 50 year lease, the issue of possible rent reductions during the term, the issue of giving MPHS first right of refusal to other district properties, the issue of the non-competitive clauses (core and non-core services), and the waiver of eminent domain?

The election measure under Health & Safety Code Section 32121 P will place the entire terms of the Agreements before the voters and voter summaries will be prepared (we believe) by your office in the usual manner for local ballot measures. We will work with your office to ensure accurate summaries of these provisions. There is no waiver of eminent domain during the proposed 50 year term of the Ground Lease, or any extension thereof, and a provision attempting such waiver in the Construction Ground Lease will be removed from the final version. Thank you for mentioning that provision.

(15) Is Sutter fully committed to this project given that there is a parallel plan to build another Sutter based hospital in fairly close proximity in San Carlos (PAMF)?

The Board believes so, and believes that the San Carlos proposal does not significantly impact the District's community and its service market. The District hosted PAMF and Sutter attended meetings at which these issues were addressed. The larger risk is that MPHS/Sutter loses commitment due to overly burdensome construction costs (a "Bay Bridge" scenario), and the District will prepare to undertake the project (or likely some significantly revised version of it), should MPHS drop its commitment. The District believes it already has a team of experts in place to assist such contingency planning.

Please feel free to contact me with any follow up questions you may have, and again thank you for your work and input.

Very truly yours,

Colin J. Coffey, General Counsel
Peninsula Health Care District

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