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August 8, 2008

Ms. Janis Sigman
Manager, Facility Certification Program
Department of Health
PO Box 47890
Olympia, WA 98504-7890

**Re: Empire Health Services/Deaconess Medical Center and Valley Hospital
and Medical Center**

Dear Ms. Sigman:

I. Introduction

State law requires that the Attorney General provide the Department of Health (the Department) with an opinion as to whether a proposed acquisition of a nonprofit hospital by a for-profit buyer complies with certain statutory criteria. RCW 70.45.060. The Department has received an application from two wholly-owned subsidiaries of Community Health Systems, Inc. (CHS),¹ for the acquisition of specified assets of Empire Health Services (Empire). Hospital Sales Review Application (Application) (Jan. 11, 2008). CHS is a publicly-traded hospital company, organized on a for-profit basis. As of the date of its initial Application, CHS owned over 125 affiliated hospitals in 28 states. Application, Introductory Statement to Acquisition Application (Introductory Statement) at 5. Empire is a Washington nonprofit corporation that owns two hospitals, and other assets. The two hospitals are Deaconess Medical Center (Deaconess), located in Spokane, Washington, and Valley Hospital and Medical Center (Valley), located in Spokane Valley, Washington.

In preparing this opinion, we have reviewed the Application and other materials submitted by CHS and Empire in support of CHS's Application.² We have also considered

¹ The two subsidiaries are Spokane Washington Hospital Company, LLC, which proposes to buy Deaconess Medical Center, and Spokane Valley Washington Hospital Company, LLC, which proposes to buy Valley Hospital and Medical Center. Throughout this opinion we refer to CHS and its subsidiaries collectively as "CHS," except where necessary to refer specifically to one of the subsidiaries as a distinct legal entity.

² Some of the documents submitted in support of the application appear in multiple forms, reflecting changes made while this application has been pending, often in response to our questions. In

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comments and analysis from other interested groups and members of the public, as well as the opinion of the independent consultant the Department engaged to value the hospitals. Appendix 1, attached to this opinion, identifies and describes the principal documents we reviewed. We have also received materials submitted in support of CHS's application for certificates of need.

Given the number of entities and institutions involved directly or indirectly in this acquisition, and the sometimes complex interrelationships among them, we have set forth in Appendix 2 a table identifying such parties and the abbreviations used to refer to them in this opinion. Additionally, because of the large number of documents we reviewed in preparing this opinion, we have set forth in Appendix 3 a table listing the abbreviations used in citations, identifying the documents to which those abbreviations refer, and describing their source.

II. Executive Summary

Our review of this proposed acquisition is limited to whether it satisfies the criteria set forth in RCW 70.45.070. Specifically, whether (1) the proposed acquisition is permitted under chapter 24.03 and other laws governing nonprofit entities, trusts or charities, (2) the nonprofit corporation that owns the hospital being acquired exercised due diligence with regard to the sale, (3) the procedures used by the nonprofit corporation's board of trustees in making decisions fulfilled their fiduciary duties, (4) any conflict of interest exists related to the acquisition, (5) the nonprofit corporation will receive fair market value for its assets, (6) charitable funds will be placed at unreasonable risk, (7) any management contract under the acquisition will be for fair market value, (8) the proceeds from the acquisition will be controlled as charitable funds independently of the acquiring person or parties to the acquisition, (9) any charitable entity established to hold the proceeds of the acquisition will be broadly based in and representative of the community, and (10) a right of first refusal to repurchase the assets by a successor nonprofit corporation or foundation has been retained.

The sale of nonprofit hospitals, particularly longstanding community institutions such as those at issue in this proposed transaction, to a for-profit business raises a number of public policy questions. In addition, the community in which these institutions are located has a number of interests at stake. The legislature has weighed various policy issues, including the potential effects of such transactions on the preservation of charitable assets and the future provision of health care in the community. RCW 70.45.010 (legislative findings). It has made the public policy decision that the acquisition of nonprofit hospitals by for-profit entities must be approved when the criteria set forth in statute are satisfied. RCW 70.45.060. The question for us, accordingly, is whether this proposal satisfies the statutory criteria.

such instances, we cite to the most recent form of each document, unless citation to an earlier version is relevant to our analysis, such as to explain changes and developments during the process.

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The Application under review reveals that in recent years Empire has found itself in increasingly difficult financial circumstances. A number of efforts to return the hospital system to profitability have achieved only minor, temporary successes. A heavy debt load, coupled with the looming necessity for major capital investments and increased competitive pressures, has rendered turnaround efforts even more difficult.

To address these challenges, Empire retained an outside consultant, Cain Brothers Company, LLC (Cain Brothers), to advise it regarding its options for remaining a viable health care provider in the greater Spokane area. Four options for meeting Empire's strategic objectives were identified by Cain Brothers: (1) remaining an independent, stand-alone hospital system; (2) affiliating with a larger system; (3) establishing a joint venture or other joint ownership arrangement; and (4) conducting an outright sale of the hospitals.

Empire conducted a competitive process to generate a number of different proposals. Ten parties responded to Empire's solicitation. These parties are referred to throughout the materials submitted in the application and this opinion as "potential strategic partners." These potential strategic partners were: eight for-profit entities, one not-for-profit entity, and one proposal for a leveraged recapitalization combined with a management contract. Empire developed a comprehensive set of criteria by which to evaluate proposals. Following a lengthy evaluation process, Empire selected CHS as the best fit for Empire based upon CHS's culture, values, and objectives as measured against Empire's evaluation criteria.

Empire and CHS entered into a memorandum agreement and then negotiated an Asset Purchase Agreement (Agreement) under which CHS would purchase Deaconess, Valley, and other related assets.³ CHS initially offered to pay Empire \$160 million for the hospitals. Following additional due diligence on the hospitals and further financial losses, the Agreement was amended to reduce the purchase price to \$144 million due to CHS's conclusion that the hospitals' continued financial difficulties had led to a diminution in the hospitals' value. CHS's offer, as embodied in the Agreement, includes additional important features, such as a commitment to make \$100 million in capital expenditures at the hospitals within five years after the closing of the transaction. The Agreement does not provide for CHS to acquire all of Empire's membership interests in various limited liability companies and nonprofit corporations in which Empire is involved.⁴

³ In Section 1.1 and 1.2 of the Agreement, Empire and CHS outline which Empire assets are to be included and which are to be excluded. In addition, Schedule 1.2 more specifically identifies what is to be excluded. Application, Ex. BB at 4209-212; Screening Response, Attach. 14 at 1269.

⁴ In Schedule 1.2, the Agreement sets forth at least 11 entities in which Empire will retain membership interests. Screening Response, Attach. 14 at 1269; Application Ex. BB at 4212. These entities are discussed further within the body of our analysis, to the extent they are relevant.

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The Application submitted by CHS includes a proposal for the creation of a new health care foundation that would receive the net proceeds of the transaction and which would have charitable purposes consistent with those of Empire. Based upon an analysis of Empire's liabilities that would need to be discharged as a part of the transaction, it is estimated that the foundation's initial endowment will be approximately \$80.5 million. The Application further includes an initial group of proposed directors for the new Foundation.

After CHS's submission of its Application, the Department engaged KPMG LLP (KPMG)⁵ to conduct a valuation of the hospitals. In a report issued on June 20, 2008, KPMG concluded that the fair market value of the hospitals was \$132 million.

Our opinion is that, subject to certain conditions, the proposed acquisition meets the requirements in RCW 70.45.070. Among our conclusions are the following:

- This transaction is authorized by relevant state laws, including the nonprofit corporations act. Additionally, the indirect effect of this transaction upon another hospital owned by a nonprofit corporation related to Empire does not require further analysis or approval under RCW 70.45;
- Empire exercised due diligence in authorizing the sale of the hospitals, selecting CHS as the acquiring party, and negotiating the terms and conditions of the sale;
- Neither Empire nor CHS have any conflicts of interest related to the transaction;
- Empire will receive fair market value for the hospitals;
- The net proceeds of the sale will be controlled by a charitable entity which, *with certain amendments to the Application*, will operate independently of Empire and CHS and which will be broadly based in and representative of the communities in which the hospitals are located. In addition, the proceeds of the sale will be used for charitable health purposes consistent with Empire's original purpose and other applicable legal requirements; and
- The Agreement provides for a sufficient right of first refusal, on the part of the new Foundation, to purchase the hospitals if CHS later decides to sell them.

⁵ KPMG LLP's Economic and Valuation Services Practice provided the Department and the Attorney General's Office with a valuation of the sale of Empire to CHS. KPMG's findings are discussed more thoroughly in later sections of this opinion.

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This opinion sets forth our analysis pursuant to RCW 70.45.060(1) of the statutory criteria set forth in RCW 70.45.070. For the reasons that follow, we have concluded that the proposed acquisition, with the inclusion of certain amendments, satisfies the ten statutory criteria set forth in RCW 70.45.070 without the need for any further amendment or modification of the documents offered in support of the Application. In order to fully satisfy the criteria, we recommend, for reasons explained within the body of this opinion, that the Department condition its approval of the Application upon amendment of the Application as follows:

- The draft amended bylaws for the post-transaction Empire must be amended to include the requirement, set forth elsewhere in the Application, that one of the Empire directors be selected from among three nominees of the new Foundation (*see* page 11, note 11, below);
- The draft bylaws for the new Foundation must be amended to strike the requirement that when the initial board members select “a full roster of directors” within 90 days after the closing of the transaction, that their choice be limited to a slate of nominees put forward by post-transaction Empire (*see* page 47 below);
- Schedule 9, attached to the Agreement, must be amended to remove the prohibition against the new Foundation carrying out its charitable purpose through the support of hospitals that compete with CHS—although we do not recommend striking the covenant not to compete in other respects (*see* pages 49-53 below);
- The draft Foundation Agreement must be amended to explicitly state that the new Foundation holds assets distributed to it pursuant to this transaction in charitable trust (*see* page 45 below);
- The Agreement must be amended to explicitly require, rather than merely permit, Empire to distribute the net purchase price to the new Foundation (*see* page 46 below); and
- Two additional nominees to serve as initial directors of the new Foundation must be identified to provide a more broadly diverse and representative board (*see* pages 54-55 below).

III. Procedural Background

This proposed transaction began with the filing by CHS of an application for approval of its acquisition of assets of Empire. The initial application included a 44-page introductory statement, which provided general background and an overview of the proposed transaction, and a series of exhibits, totaling 4,367 pages, providing greater detail. Notably, these exhibits

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included the Agreement by which CHS proposed to acquire Deaconess and Valley. Application, Ex. BB at 4199-266 (Agreement as amended, Dec. 6, 2007).

The review began with a “screening” stage, during which the Department, in consultation with the Attorney General’s Office, reviewed the Application to determine whether it was complete. RCW 70.45.040(1). This review entailed a determination of whether the applicant had fully responded to the information required by the Department’s administrative rule governing the application process, and had provided all required documentation. *Id.*; WAC 246-312-040 (specifying required documentation). After reviewing the initial Application and supporting materials, and after consulting with this Office regarding our review of the same materials, the Department informed CHS that the Application was not complete as originally filed. Ltr. from Janis R. Sigman to Kenneth Hawkins (Mar. 5, 2008). The letter advising CHS of this determination posed 53 questions (the screening questions), requesting additional information and documents not provided with the initial Application. *Id.*

In response, CHS provided (in addition to a brief cover letter) a written response to each of the screening questions, providing additional documents in the form of 19 attachments totaling 1,878 pages. Responses to Screening Questions Related to Hospital Sales Review Application (Screening Response). At the same time, CHS also filed an amended version of the Agreement, reflecting changes negotiated between CHS and Empire after the initial filing, unrelated to the screening questions. This included a reduction in the purchase price, which CHS reflected in an amended application. Amendment to Asset Purchase Agreement (Amended Agreement) at 1. After reviewing these materials, again in consultation with this Office, the Department determined that the Application was sufficiently complete to commence review, and so notified CHS and Empire on May 8, 2008. Ltr. from Janis R. Sigman to Kenneth D. Hawkins (May 8, 2008).

On the same date, we provided counsel for CHS with a list of additional substantive questions related to the analysis provided in this opinion. Ltr. from Attorney General’s Office to Andrew Murray and John Sullivan (May 8, 2008). That letter posed nine questions seeking elaboration or clarification from CHS as to materials previously provided. CHS responded on June 6, 2008, clarifying several points regarding the Application. Responses to Screening Questions Dated May 8, 2008 (Response to Attorney General).

Additionally, the Department engaged KPMG as an independent consultant to provide expert assistance in evaluating the proposed acquisition, particularly whether the purchase price reflects the fair market value of Empire. On June 21, 2008, we received KPMG’s final report on the valuation of Empire and the assets that CHS proposes to acquire. *State of Washington’s Department of Health, Valuation of Empire Health Services as of April 30, 2008* (KPMG Report). The authors of that report met with us, along with Department staff, to orally review that report and to respond to our questions.

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We also received substantial input from other persons and organizations in the Spokane community. In addition to numerous other letters and email messages listed in Appendix 1, this included detailed analyses of the proposed transaction from counsel for Providence Health & Services (Providence), owner of two competing nonprofit hospitals and partner with Empire in several nonprofit corporations. *See, e.g.,* Melissa Englemann, Lori Nomura, Mike Vaska (Foster Pepper PLLC), *Proposed Conversion of Spokane's Deaconess and Valley Hospitals: Public Impacts of Community Health System's Failure to Continue Empire's Commitments to Charity Care and Other Community Benefits* (Providence Assessment of Impacts). Numerous community organizations, labor unions and churches joined together as the "Protect Our Hospitals Coalition" (Coalition) and offered their views and analysis of the proposal, doing so through legal counsel provided by Columbia Legal Services. The Coalition also provided extensive written comments on the proposed transaction. *See, e.g.,* Protect Our Hospitals Coalition, *Public Comments Regarding Hospital Sales Review Application to Purchase Deaconess Medical Center and Valley Hospital and Medical Center* (June 25, 2008) (Coalition Public Comments). On June 25 and 26, 2008, the Department conducted two public hearings, one each in Spokane and Spokane Valley, to receive testimony from members of the public concerning the proposed acquisition. Additionally, counsel for Empire responded in writing to additional questions that we posed concerning the proposed transaction. Ltr. from Kelley Taylor Hearne to Jeffrey T. Even (July 3, 2008) (July Hearne Ltr.). Finally, CHS provided, at the Department's invitation, a written response to the public testimony. Ltr. from Andrew J. Murray to Janis R. Sigman (July 11, 2008) (Response to Public Comments).

IV. Factual Background

A. Spokane-Area Hospitals

Empire is a nonprofit corporation that directly operates two hospitals, Deaconess and Valley, and additionally owns other related healthcare facilities and equipment, such as medical office buildings and outpatient care facilities. Application, Ex. BB at 4209 (Agreement at 1). Empire also owns and operates four urgent care centers and a multi-specialty physician practice. KPMG Report at 8 (describing First Care Urgent Care Centers and Health Providers Northwest). The larger of the two hospitals, Deaconess, is located in downtown Spokane and was founded in 1896. It is currently a fully-accredited 388-bed facility, and includes a level II trauma center and level III perinatal center. Introductory Statement at 4. Deaconess is a major regional hospital, providing services to residents of eastern Washington, northern Idaho, western Montana and northern Oregon, including treatment of heart and vascular diseases, cancer, and services for mothers and newborn babies. KPMG Report at 5. Empire also owns and operates Valley, located in Spokane Valley, which is a 123-bed acute care facility founded in 1969. Introductory Statement at 4-5. Serving the Spokane Valley area, "Valley has historically had a strong focus of OB/GYN" (KPMG Report at 7), with a growing volume of emergency room patients. *Id.*

