



HEALTH SERVICES AGENCY
ADMINISTRATION

COUNTY OF SANTA CRUZ ¹³³

HEALTH SERVICES AGENCY

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August 26, 1998

AGENDA: **September 1, 1998**

BOARD OF SUPERVISORS

County of Santa Cruz
701 Ocean Street
Santa Cruz, CA 95060

Subject: **REPORT ON WATSONVILLE COMMUNITY HOSPITAL SALE**

Dear Members of the Board:

I have written to you previously concerning a range of issues associated with the planned sale of the Watsonville Community Hospital to Community Health Systems of Brentwood, Tennessee. Sales negotiations are nearly concluded with sale closure expected as early as the first week of September.

Watsonville Community Hospital's (WCH) efforts to secure a partner or a buyer for their facilities began in the summer of 1996 when the WCH Board of Directors became convinced that a decline in the hospital's finances and utilization could only be reversed by finding an outside organization with sufficient resources to make the financial and programmatic investments necessary for the hospital to survive.

Once that decision was made, the hospital began a search which involved a number of consultants, Requests for Proposals, and other types of solicitations seeking expressions of interest in either an affiliation or a purchase. At the same time, the hospital initiated a number of fiscal stringencies including reducing their budget by \$6 million (approximately 10%) in 1996-97 and reducing the number of employees by 68 FTE's. Although these cuts temporarily stabilized WCH's financial difficulties, they did nothing to revitalize the hospital, allow it to recapture market share or to make organizational changes necessary to be competitive in the health care industry.

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In late 1996, WCH identified three possible candidates for affiliation or purchase; Catholic Healthcare West (CHW), Sutter Health and **Columbia/HCA**. During early 1997, discussions with these three potential candidates **insued** but at a leisurely pace. In July 1997, **Columbia/HCA withdrew** from further discussions because of their own restructuring issues. The WCH Board determined that additional discussions with CHW would be difficult because of anti-trust issues associated with **CHW's** Dominican Hospital in Santa Cruz which is subject to a Federal Trade Commission restraining order restricting hospital expansion.

With **Columbia/HCA** and CHW out of the picture, Sutter Health remained the only potential candidate of the original three. The Watsonville Board decided to solicit additional proposals and, in response, received an indication of interest from Community Health Systems (CHS). This initial interest later resulted in a **CHS/WCH** letter of intent in January, 1998 for the two organizations to exclusively negotiate with one other. These exclusive negotiations ultimately resulted in an offer from CHS to purchase the hospital. This offer was detailed in a letter to the California State Attorney-General dated May 29, 1998. Between January, 1998, when the two organizations entered into their exclusive letter of intent, and May 29, 1998 when a formal offer was submitted, a number of intervening activities took place.

Shortly after exclusive negotiating commenced, Community Health Systems made a provisional offer to pay in the range of \$70 million dollars for WCH. This offer was subject to various due diligence activities that would occur in the intervening period and was subject to appraisals which the buyer would obtain from a national financial and accounting firm. In March of 1998, Deloitte & Touche LLP determined the value of the hospital was in the range of \$48 to \$56 million. In response, CHS adjusted their offer downward to a net of \$58.5 million. CHS offered to WCH an all cash deal and specifically excluded certain assets of WCH including the old hospital on Green Valley Road and certain receivables associated with pending cost reports. The intent was that these assets would remain with WHC and that they would be ultimately convert to community-based charitable activities as required by state law.

At the time the proposed sale of WHC to CHS was formalized in the May 29th submittal to the Attorney-General, a complicated legal process began. The Attorney-General, pursuant to 1996-97 legislation (sponsored by Assemblyman Phil Isenberg and referred to as the "Isenberg Act:), is mandated to preside over the sale of "not-for profit" organizations to "for profit" organizations. The purpose behind the legislation is to assure that the public interest is represented and that assets which were accumulated under a protected tax status by a "not-for profit,, organization would not go to the benefit of a "for profit" organization; rather that they would be used for the public benefit which would be related to the activities which generated the assets in the first place. The Attorney-General's task, to preside over and approve a conversion, is a daunting one. Further complicating matters is that the governing statutes require that the **Attorney-General** to complete the process in a 90 day period. While there are provisions for extensions, there is great pressure not to extend the period of time and to proceed

quickly. It is this speed of review, punctuated by the complexity of the deal, which has stimulated much of the community concern about having some of their rights to review and involvement being short-circuited.

At the time the proposal to sell the hospital was submitted to the Attorney-General, and the review process began, the Health Services Agency on behalf of the County, had already indicated its concern to the Attorney-General and to the selling and buying parties. The County's interests included the medical impact on the community, the use of the residual assets, and the importance of continuing access to health care for indigents and poor persons, many of whom looked to the County and Watsonville Hospital for their medical care.

The County was not the only interested governmental organization. The City of Watsonville was also interested. After a number of discussions, the Council ultimately resolved to endorse the sale. Also forming at the time of the proposal was an ad hoc group called the Pajaro Valley Coalition for Health Care Services. This coalition was spear-headed by the Central Labor Council of Santa Cruz and Monterey counties, other labor organizations which represented Watsonville Hospital employees, representatives of Salud Para La Gente, the Community Action Board of Santa Cruz County, and other interested organizations and individuals. The County participated in this coalition also.

Working both with the coalition and as an independent entity was Consumer's Union (CU) of California. Consumer's Union, which publishes Consumer Reports Magazine, has a San Francisco office which works on public benefit conversions in the health care field. CU has several staff attorneys who are expert in this area. They advised the Pajaro Valley Coalition on a number of considerations and ultimately provided independent comment to the Attorney-General. CU has, from the outset, opposed the conversion. The focus of their opposition changed as the months passed, but in the end they remained in opposition. In general, CU opposes non-profit to private conversions in the health care field.

The Attorney-General is required by statute to hold a public hearing on conversions of this nature. The mandated hearing took place on August 1, 1998. In response to an outcry from the community about the timing and the early and restricted notice, a second public hearing was held on August 24, 1998. In addition, the Attorney-General has met with the Pajaro Valley Coalition and a number of interested community groups, and has contacted County staff and been available for conversations and discussions on a variety of issues.

The issues, after months of discussion and review, are represented in the following major areas:

1. Value

The new Watsonville Hospital was completed and opened in the spring of 1998 at a construction cost in excess of \$70 million. The original offer from CHS to buy the hospital and its assets and business was for \$71 million, but was conditioned on a thorough evaluation of the hospital and a number of due diligence activities. The CHS offer was subsequently reduced to \$58.5 million which is the sale price now pending.

There was, and remains, a great deal of concern in the community that the hospital sales price does not represent the hospital's true value. Based upon this community expression of concern as well as the Attorney-General's own reviews, the Attorney-General commissioned a review of the original Deloitte & Touche evaluation by the San Francisco firm of Houlihan Lokey Howard & Zukin. That firm provided the Attorney-General with a written report on August 18, 1998, the essence of which was that Houlihan, et al, determined that the hospital's value was about \$50 million; less than the pending \$58.5 million offer.

While the matter of value remains in contention, the Attorney-General is satisfied with the evaluation, the seller and buyer are satisfied with their negotiated price, and it seems unlikely that it will change.

2. Health Impact on the Community Because of the Sale

Much concern was expressed that when WCH sold to a private, for-profit, out-of-state hospital-chain that health care in the community would suffer. In the proposal to sell and buy, encompassed in a document entitled the Asset Purchase Agreement, both the buyer and the seller asserted there would be no adverse impact on community health care services as a result of the sale. In fact, they asserted that health care services would be improved because the buyer would have sufficient resources to fund an expansion of services and that the buyer was committed to operating the hospital over the long term and making it successful.

As with the value of the hospital, this issue has been a continuing source of discussion and contention. The Asset Purchase Agreement included documents reflecting the array of health care services in Santa Cruz County in general, and the Pajaro Valley area in particular. These, however, were generally viewed as too broad in their perspectives and not sufficiently focused to answer the question about whether the sale would adversely impact health care in the immediate Watsonville area. Because of these considerations, the Attorney-General invoked his authority and contracted with the Camden Group of El Segundo, CA to do a health impact study. This study, which was released on August 18, 1998, concluded that there would be no adverse impact because of the sale and, in fact, concluded that the access to health would be improved by the acquisition of WCH by CHS. Page 62 of the Camden Report states "it is anticipated that CHS' acquisition of WCH will not have a negative effect on the availability or accessibility of health care services to the affected community. It is

expected that CHS' breadth of resources and services will stabilize the facility and provide numerous benefits to the community."

The Camden study noted further that Community Health Systems and the county had reached agreement on two important elements; one was a definition of emergency care to be provided under CHS management, and the second was an agreement, in principle, to extend to the year 2010 the existing contract between the County and Watsonville Hospital for the provision of indigent care. This agreement, which has been signed by CHS and will be presented to your Board in the coming few weeks, is basically the same agreement that exists now between the County and Dominican Hospital, the County **and** Sutter Hospital, and the County and Watsonville Community Hospital under its current ownership. This agreement provides for care to be rendered under County auspices to Medi-Cruz patients and also sets forth a standard of indigent care that each hospital in the County agrees to provide and to document.

3. Community Assets Preservation

From the beginning of discussions on a sale, County staff have been concerned that sufficient assets be available after the sale to endow a community-based foundation which would exist in perpetuity to support health care in the Watsonville and Pajaro Valley areas. Determining whether funds would be available and the magnitude of funds has been a challenging task.

This deal is structured to require that some of the assets that ultimately go to the community will remain in an escrow account for up to four years. Therefore, an evaluation of assets must distinguish between those that are immediately available and those that will ultimately be available. Based upon a number of discussions and reviews with **officials** of both WCH and CHS, and the best estimate of County staff, the ultimate asset value to the community appears to be in the range of \$10-\$15 million. This number could be substantially higher if certain factors are resolved to the benefit of the community trust, but it is unlikely to drop below this range. It is estimated that between \$6 and \$8 million will be available at the close of the deal. By the end of the first year, this could grow to between \$9 and \$11 million. Subsequent amounts should come in Year 2, Year 3 and finally at Year 4 when the deal concludes.

In addition to the assets from the sale, the seller and buyer excluded the old hospital property at Green **Valley/Holohan** Road from the original sale. That property will become an asset of the community trust. The property has a book value of \$600,000, but is generally recognized to have an actual cash value in excess of \$2 million. In addition, the Watsonville Community Hospital Foundation, which is a separate organization from the Watsonville Hospital Board-and has existed as a fund raising arm for the hospital, will fold its assets into the community-based organization. These assets include an estimated \$1 million in cash and title to more than 16 acres of land adjacent to the old hospital. Inclusion of these assets suggest that the evaluation of the Community Foundation, as noted herein, is within an accurate range.

The to-be formed community foundation, in addition to organizing itself and determining how best to fulfill its charitable purpose, will have to deal with the child care center which now operates at the old hospital and which is not part of the proposed sale. This center is a likely candidate for being spun-off to a private operator, but that decision remains to be made. In addition, the new community-based organization will have to hire staff to manage certain account receivables that will be collected by CHS, but which accrue to the benefit of the community foundation. These include outstanding cost reports and related matters. Managing these tangible assets will likely require some technical skills and consultants for the intervening period of time.

4. Charitable Trust Organization and the Charitable Trust Doctrine

When a not-for-profit organization sells to a for-profit organization, residual assets are placed in a charitable trust organization which is guided by a charitable trust charter. The Attorney-General presides over the creation of the charitable trust organization and must approve the charitable trust charter. The Attorney-General has ongoing authority to reenter a community and question the charitable trust uses if they fail to conform with the agreed upon charter.

Originally WCH proposed to convert their existing Board to take custody of the residual assets and to operate as a charitable trust organization. This did not seem acceptable in a number of quarters, including to County staff, and after a number of discussions with WCH and its Board, the Attorney-General and others, the hospital agreed to sponsor the creation of a community-based charitable trust organization to manage the residual assets. This proposal was ultimately converted into a charter doctrine which will establish a 20-member board of directors who will receive the residual assets from the sale, and under a detailed charitable charter, will organize themselves, select the type of organization that will best fit the community's needs and then begin activities to support health care in the Pajaro Valley area.

The structure calls for two members of the new Board to be nominated by the existing Watsonville hospital board, three members to be physicians, one member to be appointed by the administrator of health care services in Monterey County, and one member to be nominated by the Administrator of Health Care Services in Santa Cruz County, with that initial appointment to be the Health Officer. Additionally, the charter requires that three-quarters of the members reside in the three primary zip codes that have been the service area of Watsonville Hospital and that the composition of the Board reflect the diversity of the Watsonville community.

The Attorney-General has approved the charitable trust charter and has also agreed to broad language and authority for fund distribution. The general structure requires that 75% of the grants be for medically-related purposes with 25% for health and health education purposes. Additional authority is granted to the community charitable trust organization to determine how these various issues will meet the needs of the Watsonville and Pajaro Valley community.

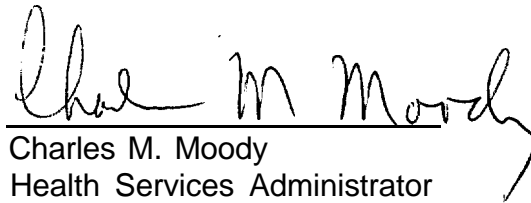
CONCLUSION:

It appears as though the sale of Watsonville Community Hospital could conclude within the next week or so. The hospital's financial situation as a stand-alone organization has continued to deteriorate, and there **is** a general sense of urgency on the part of most parties that this deal be concluded and the new owners be permitted to move forward. The likely outcome for the community should be neutral or positive as far as any health impact. The impact on Watsonville and the Pajaro Valley, however, over time with the infusion of funds into a charitable trust organization, could be one of the most significant health events to occur in its history. If the amount of funds meets the expected range of \$15 million or more, that should be a **sufficient** foundation upon which to base a robust series of health care initiatives into the future. In addition, this fund could be a magnet for attracting grants from larger health care foundations and funds throughout California and the country which desire to assist communities that are taking charge of their own destinies and seeking to resolve their own problems.

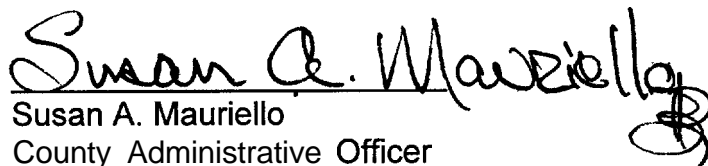
It is, therefore, RECOMMENDED that your Board:

1. Accept and file this report.

Sincerely,


Charles M. Moody
Health Services Administrator

RECOMMENDED:


Susan A. Mauriello
County Administrative Officer

CMM:js

cc: CAO
County Counsel
HSA Administration