



January 18, 2012

Neil Watkins, Board Chairman
Snohomish County Public Hospital District No. 1
doing business as
Valley General Hospital
14701 179th S.E.
P.O. Box 646
Monroe, Washington 98272-0646

Dear Mr. Watkins:

Snohomish County Public Hospital District No. 1 (the District or SCPHD) recently announced a plan to enter into a joint venture with Capella Healthcare (Capella). The new joint venture, Valley Regional Hospital, LLC (Joint Venture or Applicant), proposes to lease real estate and own substantially all of the other assets of Valley General Hospital (Hospital), which is owned and operated by the District.

Washington law establishes different processes for the acquisition (including long-term leases) of nonprofit hospitals and hospitals owned by public hospital districts. For district hospital acquisitions, the district commissioners must determine whether the proposed transaction complies with a variety of state laws, including the standards in RCW 70.45.080 addressing continued existence of accessible, affordable healthcare. To do this, the commissioners must obtain a written opinion from either the Washington State Department of Health or a qualified independent expert as to whether the proposed transaction meets the standards in RCW 70.45.080.

As a qualified independent expert, we performed the following agreed upon procedures to fulfill the requirements of RCW 70.45.080. We identified the five categories of RCW 70.45.080 which are listed below. We obtained documentation from the District and Capella that validate compliance with the requirements. That validation was included in the definitive agreements and Certificate of Need Application associated with the proposed transaction, Capella Healthcare, Inc.'s U.S. Securities and Exchange Commission Form S-4 and supporting documents, and other documents in the possession of the District and Capella Healthcare, Inc.

Compliance with RCW 70.45.080 Department review -

Criteria for continued existence of accessible, affordable health care

The department (Department of Health) shall only approve an applicant if the acquisition in question will not detrimentally affect the continued existence of accessible, affordable healthcare that is responsive to the needs of the community in which the hospital to be acquired is located. To this end, the department shall not approve an application unless, at a minimum, it determines that:

1. Sufficient safeguards are included to assure the affected community continued access to affordable care and that alternative sources of care are available in the community should the acquisition result in a reduction or elimination of particular health services.
2. The acquisition will not result in the revocation of hospital privileges.
3. Sufficient safeguards are included to maintain appropriate capacity for health science research and health care provider education.
4. The acquiring person and parties to the acquisition are committed to providing health care to the disadvantaged, the uninsured, and the underinsured and to providing benefits to promote improved health in the affected community. Activities and funding provided under RCW 70.45.070(8) may be considered in evaluating compliance with this commitment.
5. Sufficient safeguards are included to avoid conflict of interest in patient referral.

Based on the information presented below and the completion of the agreed upon procedures, Wipfli, LLP believes the acquisition in question will not detrimentally affect the continued existence of accessible, affordable healthcare that is responsive to the needs of the community in which the hospital to be acquired is located and is in compliance with the requirements established in RCW 70.45.070(8).

This report is intended solely for the information and use of the District and Capella Healthcare and is not intended to be and should not be used by anyone other than those specified parties.

If you have any questions or require additional information, please call Michael R. Bell at 509.489.4524.

Sincerely,

Wipfli LLP

Wipfli LLP

Enclosures

Valley Regional Hospital, LLC
Compliance with RCW 70.45.080 Department Review –
Criteria for continued existence of accessible, affordable health care

1. ***Sufficient safeguards are included to assure the affected community continued access to affordable care and that alternative sources of care are available in the community should the acquisition result in a reduction or elimination of particular health services. RCW 70.45.080(1).***

Continued Access to Care

The Applicant has demonstrated sufficient safeguards to ensure continued access to care through the following actions:

- ***Defined Commitment to Continue Services***

The District, in conjunction with Capella Healthcare, has agreed that Valley Regional Hospital, LLC (VRH), the joint venture entity that will be formed as a result of the proposed transaction, will continue to provide the same scope of health services currently provided by the District (as of the effective date of the transaction) for a period of 12 months immediately following the completion of the transaction.¹ Following this initial 12 month period, VRH will continue to provide all essential services now provided to the community unless otherwise directed by its governing board, as described below.

- ***Equal Membership on Governing Board***

The District and Capella Healthcare have agreed to a governance structure that will enable members of the Monroe community and Snohomish County Public Hospital District #1 to maintain an active role in determining the programs and services provided by VRH in the future. As outlined in the Operating Agreement, the parties propose the formation of the LLC Board, a six-member governing body, which will be comprised of three (3) voting members appointed by Capella and three (3) voting members appointed by the SCPHD #1 Board of Commissioners for such time as the District maintains at least a 5 percent ownership position in the joint venture.² Among its principal responsibilities, the LLC Board will have complete authority over all decisions involving the expansion, discontinuation, or other material changes in the scope of any core health care service provided by VRH following the completion of the 12-month service commitment period (as described above).³

¹ Operating Agreement, Section 10.10.

² Operating Agreement, Section 12.1(a).

³ Operating Agreement, Section 12.1(c)(xii).

- Financial Resources/Support to Ensure Continuation of Services

The District and Capella Healthcare have further demonstrated their commitment to the continued provision of health services within the affected community by ensuring that financial resources and capital reinvestment will be made following the completion of the proposed transaction. Specifically, the parties have agreed to the following financial terms, which are outlined in the definitive agreements governing the transaction:

- *Working Capital Commitments* - As documented in the Operating Agreement, VRH will participate in Capella Healthcare’s Cash Management System, which will provide the joint venture with up to \$15 million in revolving credit to satisfy any shortfall that may exist in funding day-to-day operations of the hospital.⁴ This funding is part of the existing \$100 million revolving line of credit established by GTCR, LLC, Capella Healthcare’s venture capital partner and is secured by Capella’s accounts receivable, inventory, and certain related assets.⁵
- *Pre-Defined Capital Investment* – As a result of negotiations between the parties, VRH will commit between \$14 million and \$18 million for capital investment in the first four years following the close of the proposed transaction for new equipment and equipment replacement, new facilities and facility renovations, medical office space, development of new services, information systems, and other capital needs as determined by the LLC Board.⁶ Following the fourth anniversary of the transaction, the average annual capital commitment will be equal to three percent (3%) of hospital net revenue in the preceding year.
- *Funds for Physician Recruitment/Retention* – Similarly, VRH will spend no less than \$600,000 per year in each of the first four years following the close of the proposed transaction to support physician recruitment and retention efforts undertaken by the joint venture.⁷ To the extent permissible under applicable law, recruitment and retention support may include sign-on bonuses, student loan repayment assistance, relocation assistance, income guarantees, subsidies for practice losses and, as appropriate, physician salaries in order to ensure that physician professional services are available to the residents of Monroe and SCPHD #1.
- *Pledge of District Tax Revenues* – Finally, as outlined in the Operating Agreement, the District has pledged a portion of its annual tax revenues to VRH during the first seven (7) years following the close of the proposed transaction to fund certain clinical programs and other initiatives which direct-

⁴ Operating Agreement, Section 9.3.2.

⁵ Capella Healthcare, Inc. Form S-4, F-32. (ATTACHMENT A)

⁶ Operating Agreement, Section 10.4.

⁷ Operating Agreement, Section 10.5.

ly impact access to, and the delivery of, healthcare services for the local community served by the hospital and the residents of SCPHD #1.⁸ The amount that will be pledged by the District will range from \$500,000 to \$750,000 per year and the initiatives for which such tax revenues will be used will be determined by the District. The scope of such initiatives is expected to include financial support for existing clinical programs, development or reestablishment of clinical programs (e.g., obstetrics), enhancing physician recruitment and development, and/or funding equipment or other capital needs for clinical programs offered by the hospital.

- *Continued Services for Medicare and Medicaid Beneficiaries.*

As documented in the Operating Agreement, for a minimum period of five years following the completion of the proposed transaction, VRH will participate in the Medicare and Medicaid programs and will continue to accept program beneficiaries.⁹

Affordability of Care

The Applicant has demonstrated sufficient safeguards to ensure that healthcare services remain affordable through the following actions:

- *Adoption of Current Charity Care Policy*

As documented in the Operating Agreement, VRH will adopt and maintain the existing charity care policy of the District or a new policy adopted by the LLC Board which will be subject to approval by the Washington Department of Health.¹⁰ This is relevant within the context of RCW 70.45.080(1) as it demonstrates VRH's commitment to ensuring that health services remain accessible for members of the affected community with limited resources to pay for care.

The District's charity care in 2010 was equal to 6.73 percent of adjusted hospital revenue as compared to the average charity care across all other hospitals in the Puget Sound region, which was equal to 4.42 percent of adjusted revenue.¹¹ By adopting the existing policy, VRH anticipates providing a level of charity care that is higher than its peers. This expectation is further supported by the pro forma for the joint venture, in which charity care is projected to equal 7.66 percent of net revenues in 2012 and 7.63 percent of net revenues in 2013, respectively.¹² While charity care is expected to decline to 5.37 percent in 2014, this can be attributed to certain insurance provisions that will go into effect as a result of the Patient Protection and Af-

⁸ Operating Agreement, Section 10.9.

⁹ Operating Agreement, Section 10.11.

¹⁰ Operating Agreement, Section 12.8.

¹¹ Certificate of Need Application, p. 17. (ATTACHMENT B)

¹² *Ibid.*

fordable Care Act, which is expected to result in similar reductions in charity care for most acute care hospitals.

In addition, the Operating Agreement requires that LLC Board approve any changes to the charity care policy adopted by VRH.¹³

- Indigent Care Trust Fund

In addition to the adoption of the existing charity care policy by VRH, the parties have agreed that the District will contribute to VRH \$3,000,000 on the transaction close date and an additional \$3,000,000 on the first anniversary of the transaction to provide for indigent and charity care expenses incurred by the joint venture.¹⁴ As a result, the proposed transaction is expected to allow for at least \$6,000,000 in free care for members of the community during the first two years following the proposed transaction.

Viable Alternatives for Care

Given the aforementioned terms agreed to by the parties, it is unlikely that the proposed transaction will result in a reduction or elimination in health services. However, in the event that services are eliminated, residents of the District will have continued access to essential services from a variety of similar acute care hospitals within driving distance of VGH. A listing of other area facilities and the corresponding driving distances and times is presented below in Table 1.

Table 1 – Driving Distance and Commute Duration¹⁵

Hospital		Location	Driving Distance	Commute Duration
Providence Regional Center – Everett	Medical	Everett, WA	15.52 miles	21 minutes
Evergreen Hospital Center	Medical	Kirkland, WA	18.49 miles	23 minutes
Overlake Center	Medical	Bellevue, WA	24.92 miles	30 minutes

2. *The acquisition will not result in the revocation of hospital privileges. RCW 70.45.080(2).*

The Applicant has demonstrated sufficient safeguards to ensure the proposed transaction will not result in the revocation of hospital privileges through the following actions:

¹³ Operating Agreement, Section 12.1(c)(xi).

¹⁴ Indigent Care Services Agreement, Sections 2 and 3.

¹⁵ Driving distances and commute times verified using <http://www.mapquest.com/>. (ATTACHMENT C)

Adoption of Current Medical Staff Bylaws, Appointed Members, and Officers

As outlined in the Contribution Agreement, the parties have agreed that VRH will adopt the existing medical staff bylaws of VGH in place immediately prior to the effective date of the proposed transaction.¹⁶ As a result, the existing medical staff application, credentialing, privileging, and disciplinary processes for members of the medical staff will be substantially unchanged under the proposed transaction.

Similarly, the terms of the Contribution Agreement also require VRH to inherit the medical staff status (i.e., Active, Courtesy) and professional privileges for all members of the medical staff who are in good standing as of the transaction effective date as well as the hospital's medical staff officers, who will remain in their same positions upon completion of the proposed transaction.¹⁷

¹⁶ Contribution Agreement, Section 6.12.

¹⁷ *Ibid.*

3. Sufficient safeguards are included to maintain appropriate capacity for health science research and health care provider education. RCW 70.45.080(3).

The Applicant has demonstrated sufficient safeguards to ensure that the hospital's capacity for health science research and health care provider education are maintained through the following actions:

- Commitment to Evaluate Health Science Research Initiatives

As of the date of this letter (ATTACHMENT D), Ms. Lisa LaPlante, Director of Compliance and Organizational Development at VGH, is not aware of any past or present health science research in which VGH was an active participant. Although the hospital has not historically been involved in such research activities, the Operating Agreement for the proposed transaction outlines an explicit commitment by VRH to fully evaluate the pursuit of these initiatives, as they are presented, using the same reasonable business judgment used to evaluate other clinical programs.¹⁸

- Continuation of Existing Programs and Access to Capella Healthcare's Corporate Resources

Moving forward, the proposed transaction will expand the resources available at VGH as the human resources and risk management functions of the joint venture will be assumed by Capella Healthcare under the terms of the Management Services Agreement between Capella and VRH.¹⁹ As a result, VRH will have access to Capella Healthcare's corporate resources in these areas for the purposes of expanding both the scope and intensity of provider education programs for healthcare providers.

Additionally, the parties have explicitly outlined their commitment to ensure that Capella employees, who, through the Management Services Agreement, will provide services on behalf of VRH, will participate in a continuing program of healthcare provider education that is consistent with both the standard practices of Capella as well as the legal requirements applicable to VRH.²⁰

¹⁸ Operating Agreement, Section 10.12.

¹⁹ Management Agreement, Section 1(a).

²⁰ Management Agreement, Section 29.

4. ***The acquiring person and parties to the acquisition are committed to providing health care to the disadvantaged, the uninsured, and the underinsured and to providing benefits to promote improved health in the affected community. Activities and funding provided under RCW 70.45.070(8) may be considered in evaluating compliance with this commitment. RCW 70.45.080(4).***

Commitment to Providing Health Care to the Disadvantaged, the Uninsured, and the Underinsured in the Affected Community

The Applicant has demonstrated its commitment to provide health care to the disadvantaged, the uninsured, and the underinsured through the following actions:

- **Adoption of Current Admission Policies**
Under the proposed transaction, VRH would adopt the existing admission policies of VGH, which set forth the hospital's commitment to "...not exclude, deny benefits to, or otherwise discriminate against any person on the basis of age, race, creed, gender, national origin, religious preference, or disability in admission to participation in, or receipt of services and benefits under any of its admission, programs, activities, and services."²¹
- **Adoption of Current Charity Care Policy**
As previously stated, the Operating Agreement associated with the proposed transaction outlines VRH's obligation to adopt and maintain the existing charity care policy of the District or a new policy adopted by the LLC Board, which is subject to approval by the Washington Department of Health.²² To this end, VRH is projected to provide levels of charity care in the coming years that exceed the average level of charity care provided by similar hospitals in the Puget Sound region.
- **Indigent Care Trust Fund**
In addition to the adoption of the existing charity care policy by VRH, the parties have agreed that the District will contribute \$3,000,000 on the transaction close date and an additional \$3,000,000 on the first anniversary of the transaction to VRH to provide for indigent and charity care expenses incurred by the joint venture.²³ As a result, the proposed transaction will enable the joint venture to provide at least \$6,000,000

²¹ Based on a review of VGH's current admissions policies, which include the following: Nursing Admissions Procedures, Pediatric Patient Admission Process and Admissions Form Guidelines, Patient Admission from Emergency Department to Nursing Unit, and Admission of Patients to the ED. (ATTACHMENT E)

²² Operating Agreement, Section 12.8.

²³ Indigent Care Services Agreement, Sections 2 and 3.

in free care for members of the community during the first two years following the proposed transaction.

- *Continued Services for Medicare and Medicaid Beneficiaries.*

As documented in the Operating Agreement, for a minimum period of five years, VHR has agreed to participate in the Medicare and Medicaid programs and to accept program beneficiaries.²⁴

Commitment to Provide Benefits to Promote Improved Health in the Affected Community

The Applicant has demonstrated its commitment to promote improved health in the affected community through the following actions:

- *Continued Existence of SCPHD #1*

As of the completion date of this letter, SCPHD #1 plans to continue operations as a public hospital district in the event that the proposed transaction is completed and will seek to provide other community-based health programs that are tailored to meet the unique needs of the affected community. Such programs, which have not yet been defined, will continue to be funded through the District's collection of property tax revenues, a portion of which will also be pledged to VRH to support health services that are best provided in a hospital inpatient and/or outpatient environment.

- *Funding for Special Community Projects*

The parties have agreed that Capella Healthcare shall pay \$250,000 to the District on the transaction close date in order to provide financial support for charitable organizations in the local community served by VRH.²⁵ The District will retain authority over the manner in which these funds are used in order to maximize the benefit to the affected community.

- *Financial Resources/Support to Ensure Continuation of Services*

As previously stated, the District and Capella Healthcare have further demonstrated their commitment to health promotion within the affected community by ensuring that the necessary financial resources and capital reinvestment will be made following the completion of the proposed transaction. Within the context of RCW 70.45.080(4), these include:

²⁴ Operating Agreement, Section 10.11.

²⁵ Contribution Agreement, Section 2.4.

- *Pre-Defined Capital Investment* – As a result of negotiations between the parties, VRH will commit between \$14 million and \$18 million for capital investment in the first four years following the close of the proposed transaction for new equipment and equipment replacement, new facilities and facility renovations, medical office space, development of new services, information systems, and other capital needs as determined by the LLC Board.²⁶ Following the fourth anniversary of the transaction, the average annual capital commitment will be equal to three percent (3%) of hospital net revenue in the preceding year.
- *Funds for Physician Recruitment/Retention* – VRH will spend no less than \$600,000 per year in each of the first four years following the close of the proposed transaction to support physician recruitment and retention efforts undertaken by the joint venture.²⁷ To the extent permissible under applicable law, recruitment and retention support may include sign-on bonuses, student loan repayment assistance, relocation assistance, income guarantees, subsidies for practice losses and, as appropriate, physician salaries in order to ensure that physician professional services are available to the residents of Monroe and SCPHD #1.

²⁶ Operating Agreement, Section 10.4.

²⁷ Operating Agreement, Section 10.5.

5. Sufficient safeguards are included to avoid conflict of interest in patient referral. RCW 70.45.080(5).

The Applicant has demonstrated sufficient safeguards to avoid conflict of interest in patient referrals through the following actions:

- *Participation in the Medicare Program*

As reflected by the definitive agreements, VRH is expected to continue to participate in the Medicare Program. As a result, VRH must comply with the federal Anti-Kickback Statute and Stark Laws, which collectively prohibit physician self-referral and the exchange of anything of value in an effort to induce physician referrals to another provider entity (e.g., hospital). Failure to comply with these regulations can include denial of payment, mandatory refunds, civil monetary penalties, and/or exclusion from participation in the Medicare Program, which is the largest payor for most hospitals. Thus, VRH will be incented to ensure that all potential conflicts of interest involving patient referrals are fully evaluated in order to maintain compliance with applicable laws and regulations.

- *Access to Capella's Healthcare Corporate Legal and Compliance Functions*

In order to avoid conflict of interest in patient referral, under the terms of the Management Agreement, Capella shall cause VRH to participate in the same corporate compliance program the organization has implemented at other Capella-affiliated acute care hospital facilities.²⁸ Based on correspondence received from Mr. Tony Fay (ATTACHMENT F), Vice President of Government Relations and Compliance for Capella Healthcare, Capella's corporate program has been highly effective in ensuring compliance with all applicable laws and regulations. Specifically, Mr. Fay indicated that there have been no investigations or sanctions against any Capella hospital during the period in which the hospital was owned by Capella.²⁹

²⁸ Management Agreement, Section 28.

²⁹ Attachment F - Email correspondence provided by Mr. Tony Fay.

SUPPORTING ATTACHMENTS

ATTACHMENT A – Capella Healthcare Inc., S-4 Form.

ATTACHMENT B – Certificate of Need Application.

ATTACHMENT C – MapQuest Maps.

ATTACHMENT D – Disclosure Letter from Ms. Lisa LaPlante.

ATTACHMENT E – VGH Admission Policies.

ATTACHMENT F – Email Correspondence from Mr. Tony Fay.