R. Anatomy of an Affiliation between a Community Hospital System and Major Academic Medical Center

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Anatomy of an Affiliation between a Community Hospital System and Major Academic Medical Center: The Chester County Hospital and Health System and the University of Pennsylvania Health System

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Presentation Agenda

• The Situation at The Chester County Hospital and Health System (“TCCHHS”) in Early 2012 (Mike Duncan)
• The Strategic Affiliation Process (Carsten Beith)
• Structure and Key Elements of the Transaction (Keith Anderson)
• Lessons Learned (Panel)
The Situation at TCCHHS in Early 2012

Summary Information

- Type: Community Hospital
- Location: West Chester, PA
- Founded: 1892
- Hospitals: 1
- Beds: 245
- Revenues: $291 million
- EBITDA: $16.5 million
- Debt: $60.1 million
- Days Cash on Hand: 61
- Debt-to-Capitalization: 40.9%
- Ratings: Ba1
- Notes:
  - One of two standalone community hospitals in the region

Geographic Footprint

(1) Based on pretaxation data. Source: Financial statements for fiscal year 2011, AHA and CreditScope.
The Situation in Early 2012

High Level Challenges

- Inpatient volume off >5.5%
- Outpatient volume flat
- Ratings downgrade in April 2011
- As a result, additional borrowing extremely difficult
- Independence Blue Cross contract renewal this calendar year – early indications concerning
- Our business has been in steady decline since 2008
- Paoli Hospital continues to expand: maternity capacity (2013), trauma (2010), and new wing (2009)
- Our own plans for the New Tower (May 2013) and West Grove Project (late 2013) are just the beginning of capital requirements to get back in the game

The Situation in Early 2012

Essential Challenge

- Cannot get healthy margins with large revenue/unit increases or additional large expense reductions, so growth is essential

- Options for growth
  - Grow Emergency Department visits
  - Recruit and/or employ a broader primary care network
  - Recruit more specialists to the Medical Staff
  - Launch new tertiary programs to capture outmigration
  - Expand satellite strategy to open up new markets
  - Grow profitable ancillary and outpatient services

- The $37.5 million we borrowed plus philanthropy gets us:
  - ‘New tower with 24 private rooms
  - State of the art Radiation Oncology
The Situation in Early 2012

Additional Needs

- Approximately $29.5 to 31 million for –
  - Private Maternity (total of $14.5 to 16 million)
    - 24 beds ($10 million)
    - 14 NICU beds ($3 million)
    - Antepartum Renovation ($1.5 million)
    - OB Link ($1.5 million)
    - Total of $14.5 to 16 million
  - 24 More Private Med/Surg Beds (total of $10 million)
  - Renovate ED ($5 million)
  - West Grove Project ($5 million)

- Approximately $15 to 25 million for –
  - Buy control of the Ambulatory Surgery Center
  - Buy Physician Practices
  - Other Projects as developed in response to dynamic market

The Situation in Early 2012

Additional Needs

- Approximately $36 to 39.5 million
  - For Balance Sheet strengthening

- Total capital need in next 3 years: Approximately $80.5 to 95.5 million

- Future Capital Needs (which are currently known): Approximately $125 to 215 million for next new tower

Plus...

Note: The reason the numbers are so large is because the last major capital project occurred when Ronald Reagan was President, and gas was 93 cents/gallon.
The Situation in Early 2012

Summary

- Per unit revenue increases will be inadequate for improving margins
- Cost cutting has been all but exhausted as a means of improving margins
- Growth is essential
- Growth requires levels of capital well beyond our philanthropic capacity
- Our bond rating prevents access to capital unless we either have both a healthy balance sheet and strong margins, or we gain scale
- Partnership must be explored as a means of gaining scale so we can get access to capital

We will need philanthropy + access to capital markets

The Situation in Early 2012

Proposal to the Board in March 2012

- Advance Capital Campaign with goal of raising Phase 1 - $30 million, and
- Support Management Team exploration of partnership opportunities, which might meet our strategic financial needs and preserve essential elements of independence.
The Strategic Affiliation Process

Cain Brothers evaluated TCCHHS’ situation and managed a process to provide TCCHHS with the maximum structural flexibility and ensure that the board’s objectives were achieved

- Cain Brothers initially evaluated TCCHHS’ market position and financial situation
- TCCHHS chose to pursue an auction process based on the results of the analysis

**Process Overview**

Managing a Multi-Pronged Process

Cain Brothers evaluated TCCHHS’ situation and managed a process to provide TCCHHS with the maximum structural flexibility and ensure that the board’s objectives were achieved

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**Organization & Preparation**

- Initiate Marketing Process
  - Review of Materials
  - Initial Indications
- Management Meetings / Data Room / Diligence
- LOI

**Marketing & Preliminary Diligence**

- Potential to Move Decision Point Forward

**Final Diligence & Closing**

- Desired Path(s) Chosen
- Entitlement Confirmation Diligence with Penn
- Closing Period with Penn

**Close Transaction**

**Strategic and Financial Evaluation**

- Asset Sale
- Membership Substitution
- Joint Venture
Strategic and Financial Evaluation of TCCHHS

Objectives of Strategic and Financial Evaluation

- Identify and prioritize strategic objectives
- Analyze national and regional market dynamics
- Evaluate competitive position
- Prepare financial forecast
- Analyze TCCHHS' financial and strategic profile
- Determine capital need and capital access
- Develop strategic options

Strategic and Financial Evaluation of TCCHHS

Competitors Within 25 Miles

The competitive landscape around TCCHHS included few stand-alone facilities and was comprised mostly of regional not-for-profit systems.

- The Chester County Hospital
- Montgomery Hospital Medical Center (Standalone)
- Albert Einstein Healthcare Network (System)
- Saint Joseph's Hospital (System)
- Temple University Health System (System)
- Abington Health
- Catholic Health East
- Christiana Care Health System
- Crozer-Keystone Health System
- Main Line Health
- Penn Medicine

NOT-FOR-PROFIT HOSPITALS

- Tenet Healthcare Corp. (System)
- Prime Healthcare Services (System)
- Community Health System

FOR-PROFIT HOSPITALS
Strategic and Financial Evaluation of TCCHHS
Financial Performance relative to Market Competitors

Operating Margin

Days Cash on Hand

Strategic and Financial Evaluation of TCCHHS
Financial Performance relative to Market Competitors (Cont’d)

Debt-to-Capitalization

Average Age of Plant

Source: S&P Global Credit Portal and CreditScope.
TCCHHS had experienced significant decline in admissions over the past four years and projected only moderate improvement over the next few years.

With no debt capacity under its current rating, TCCHHS was challenged to fund the estimated $275 million in capital over the next ten years necessary to return to equal footing with market competitors.
TCCHHS' board and management developed the following key objectives for the organization:

- Access to capital
- Seek to maintain local control
- Improve medical staff complement
- Long-term viable, high quality system
- Maintain and grow clinical services
- Strengthen balance sheet

**Advantages Considerations**

- High risk
- Limited capital for recruitment and investments
- Challenging competitive position
- Provides minimal capital support
- Antitrust concerns
- Fewer synergies than in a full merger
- Only limited integration
- Balances maintaining control with capital support
- May relieve competitive pressures
- Substantial loss of control
- May retain board seat
- Loss of control and not-for-profit status
- Mission driven by shareholder returns

**Evaluating Strategic Alternatives**

<table>
<thead>
<tr>
<th></th>
<th>Advantages</th>
<th>Considerations</th>
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<tbody>
<tr>
<td><strong>Remain Independent</strong></td>
<td>• Retain governance and management control</td>
<td>• High risk</td>
</tr>
<tr>
<td><strong>Joint Operating Agreement</strong></td>
<td>• Some synergies and economies of scale</td>
<td>• Provides minimal capital support</td>
</tr>
<tr>
<td><strong>Partnership / Joint Venture</strong></td>
<td>• Retain ownership and separate boards</td>
<td>• Antitrust issues</td>
</tr>
<tr>
<td><strong>Partnership / Joint Venture</strong></td>
<td>• Maintain certain reserved powers</td>
<td>• May be more complicated without incremental benefit</td>
</tr>
<tr>
<td><strong>Membership Substitution</strong></td>
<td>• Balances maintaining control with capital support</td>
<td>• Longer transaction process</td>
</tr>
<tr>
<td><strong>For-Profit Asset Sale</strong></td>
<td>• May relieve competitive pressures</td>
<td>• Substantial loss of control</td>
</tr>
<tr>
<td><strong>For-Profit Asset Sale</strong></td>
<td>• Can address competitive risks</td>
<td>• May retain board seat</td>
</tr>
<tr>
<td><strong>For-Profit Asset Sale</strong></td>
<td>• Potential for significant operational experience, capital and other resources</td>
<td>• No net proceeds</td>
</tr>
<tr>
<td><strong>For-Profit Asset Sale</strong></td>
<td>• Net proceeds</td>
<td>• Mission driven by shareholder returns</td>
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Evaluating Strategic Alternatives
Factors Determining Best Strategic Alternative

The best strategic alternative depends on a number of factors

- TCCHHS’ financial strength
- Priority of strategic objectives to be achieved from a transaction
- Valuation and net cash equity (if any)
- Long-term strategic implications
- Impact on competitive position

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Auction Process
Evaluation Matrix

<table>
<thead>
<tr>
<th>Criteria for Consideration</th>
<th>Weight</th>
<th>Transaction Impact</th>
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<tbody>
<tr>
<td>Access to capital</td>
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<tr>
<td>Governance</td>
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<tr>
<td>Alignment with population health mission/mission</td>
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<td>Readiness to implement population health management</td>
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<td>Quality and quality tools</td>
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<td>Affordability</td>
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<tr>
<td>Access (network/points of care)</td>
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<tr>
<td>Brand</td>
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<td>Primary Care MD network</td>
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<td>Integrated IT platform</td>
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<tr>
<td>Ability to recruit and retain clinical talent</td>
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<td>Complementary geography</td>
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<tr>
<td>Leverage existing clinical relationships</td>
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<tr>
<td>Clinical program depth</td>
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<td>Insurance product/risk management</td>
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<td>Teaching programs</td>
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<td>Philanthropy</td>
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<td>Community acceptance</td>
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<tr>
<td>Reputation as employer</td>
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<td>Economic development benefits</td>
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<tr>
<td>For-Profit vs Not-For-Profit</td>
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<tr>
<td>Valuation and Net Proceeds</td>
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<tr>
<td>Unique Obstacles to Strategy</td>
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## Auction Process

### Solicitation Process

<table>
<thead>
<tr>
<th>Potential Parties Contacted</th>
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<tr>
<td>17 Not-for-Pros</td>
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<table>
<thead>
<tr>
<th>Confidential Information Memorandum Distributed</th>
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<tr>
<td>9 Regional Not-for-Profit</td>
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<tr>
<th>Indications of Interest Received</th>
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<tr>
<td>3 Regional Not-for-Profit</td>
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<tr>
<th>Reasons for Declining</th>
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<tr>
<td>Competitive profile of market</td>
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## TCCHHS considered the following factors in selecting Penn Medicine ("Penn") as its ultimate partner

### Advantages
- Substantial capital commitment and future access to capital
- Long-term commitment to TCCHHS’ existing acute care facility
- Alignment with population health mission / vision
- Strong brand
- Ability to recruit and retain clinical talent
- Clinical program depth / access to strong tertiary and quaternary care
- Teaching programs
- Reputation in the community
- Complementary geography and meaningful primary care network

### Considerations
- No net proceeds
- Limited governance rights (for limited period, representation on Penn board and Penn executive committee)
- Most post-closing covenants (including capital commitments) subject by indemnification claims
**Auction Process**

*Why Penn Medicine?*

**Summary Information**

- Type: Academic Medical Center
- Headquarters: Philadelphia, PA
- Formed: 1993
- Hospitals: 3
- Beds: 1,559
- Revenues: $3.2 billion
- EBITDA: $461.3 million
- Debt: $802.2 million
- Days Cash on Hand: 154
- Debt-to-Capitalization: 37.9%
- Ratings: Aa3/AA-/NR

**Notes:**
- Large network of clinical care providers throughout greater Philadelphia region
- Traditionally not been acquisitive

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**Geographic Footprint**

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**Overall Transaction Timeline**

- **Decision to move forward with affiliation process**
- **Cain Brothers engaged – May 2012**
- **Phase I Analysis completed and presented to TCCHHS Board – June 26, 2012**
- **NDAAs distributed and executed – Aug. 6 – 27, 2012**
- **Proposals received from interested parties – Sept. 14 – 28, 2012**
- **Proposals presented to TCCHHS Board – Oct. 3, 2012**
- **Proposals vetted and preliminary terms discussed; Modified proposals received and reviewed – Sept. 14 – 28, 2012**
- **Confidential Information Memorandum distributed to interested parties – Aug. 7 – 28, 2012**
- **Special Committee’s Interviews of Potential Partners – Nov. 1, 2, and 16, 2012**
- **Focused Negotiating Period with UPHS – November through May, 2013**
- **Fully Executed LOI/Term Sheet with UPHS – Jan. 7, 2013**
- **Fully executed Affiliation Agreement with UPHS – May 31, 2013**
- **Closing – Sept. 1, 2013 (16 months)**
- **HHS and State regulatory process (AG and DOH) – June 1 – August 31, 2013**
- **Diligence and Reverse Diligence – Jan. 8 – May 20, 2013**
- **Focused Diligence – January through May, 2013**

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(1) Based on pre-transaction data. Source: Financial statements for fiscal year 2011, AHA and CreditScope.
Structure and Key Elements of the Transaction

Initial Strategic Objectives

- Commitment of significant capital and improved access to capital markets
- Improvement of strategic position in the market
  - Managed care contracting
  - Enter or expand in key markets
  - Add programs, facilities, and equipment
  - Program synergies with partner
  - Defensive elements
- Long-term commitment to keep hospital as full service acute care facility
  - Minimum commitment to maintain identified core services
- Preserve local independence, governance and management
  - What does “independence” mean?
- Cultural fit of prospective partner
- Protect employees and preserve work force in place
  - Positions/titles, duties/responsibilities, salary/benefits, and severance
**Structure and Key Elements of the Transaction**

**Initial Strategic Objectives**

- Protect the physicians on the Medical Staff
- Recruitment of physicians to the community and medical staff
  - Employment of additional physicians
- Improve and expand quality initiatives and shared savings arrangements
- Commitment to IT and EMR
- Commitment to the mission – charity care and community benefit
- Reduce costs through economies of scale and efficiencies
- Certainty of transaction completion

**Structure and Key Elements of the Transaction**

**Strategic Alternatives – Seller’s Tradeoff Matrix**

<table>
<thead>
<tr>
<th>Access to Capital</th>
<th>Level of Control</th>
<th>Affiliation Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>High</td>
<td>High</td>
<td>High</td>
</tr>
</tbody>
</table>

- Asset Purchase
- Merger or Consolidation
- Membership Substitution
- Joint Venture (new entity)
- ACO
- Joint Operating Agreement
- Transfer of Controlling Interest
- Long-Term Lease
- Transfer of Majority Interest
- Strategic Affiliation
- Clinical Affiliation
- Status Quo

**Post Transaction Risk**

- High
- Low
Structure and Key Elements of the Transaction
Transaction Structures and Terms

- **Consideration of transaction structures in light of TCCHS’s strategic objectives**
  - Membership substitution
  - Asset sale
  - Joint venture
  - Joint operating agreement

- **Key term sheet provisions**
  - Structure – membership substitution
  - Amount and form of consideration
  - Allocation of balance sheet
  - Access to capital
  - Governance
  - Approach to maintaining clinical excellence
  - Approach to existing employment practices and retention
  - Commitment to the community
  - Charity care policy
  - Medical staff recruitment strategy
  - Other post-Closing covenants
Structure and Key Elements of the Transaction

Corporate Structure Before the Transaction

- Individual Voting Trustees of The Chester County Hospital Foundation, Inc.
- Turk's Head Health Services, Inc., For-Profit Taxable
- Professional Providers, Inc., Nonprofit Taxable
- The Chester County Hospital Foundation, Inc., Nonprofit Tax-Exempt
- Chester County Hematology/Oncology Services, Nonprofit Tax-Exempt
- Chester County Obstetrics/Gynecology Services, Nonprofit Taxable

Structure and Key Elements of the Transaction

Corporate Structure After the Transaction

- The Trustees of the University of Pennsylvania
- Affiliation Agreement
- Turk's Head Health Services, Inc., For-Profit Taxable
- Professional Providers, Inc., Nonprofit Taxable
- The Chester County Hospital Foundation, Inc., Nonprofit Tax-Exempt
- Chester County Hematology/Oncology Services, Nonprofit Tax-Exempt
- Chester County Obstetrics/Gynecology Services, Nonprofit Taxable
- Neighborhood Health Agencies, Inc., Nonprofit Tax-Exempt
Structure and Key Elements of the Transaction
Membership Substitution

- **Affiliation Agreement**
  - Parties:
    - The Chester County Hospital and Health System ("TCCHHS"),
    - The Chester County Hospital Foundation, Inc. (the "Foundation"),
    - The Chester County Hospital ("TCCH"), and
    - The Trustees of the University of Pennsylvania (the "University")
  - Key sections
    - Transfer of membership and governance
    - Representations and warranties
    - Pre-Closing covenants
    - Conditions precedent to Closing
    - Closing
    - Post-Closing Covenants, including limitations on covenants in lieu of indemnification
    - The Foundation
    - Termination

Structure and Key Elements of the Transaction
Membership Substitution

- **Amended and Restated Articles of Incorporation and Bylaws of TCCHHS and TCCH**
  - Exhibits to the Affiliation Agreement
  - Implemented the membership substitution and new governance structure
    - The University became the sole member of TCCHHS
    - New Board structure for both TCCHHS and TCCH
    - Member's reserve powers
    - Penn Medicine designated to exercise the powers of the University as the sole member of TCCHHS
      - The University established Penn Medicine as a unified governance structure for the University's medical education, research, and clinical health care constituents
      - Subject to certain powers reserved to the University, the University has delegated responsibility for oversight and governance of the University of Pennsylvania Health System ("UPHS") and its constituents to Penn Medicine
Structure and Key Elements of the Transaction

Key Elements

- Governance of TCCHHS
  - Board composition
    - Majority comprised of Community Directors and Physician Directors
    - Remainder are Penn Medicine Directors
  - Appointment of Directors
    - Initial Board identified in the Affiliation Agreement
    - Transition Period (3 year period immediately after Closing)
      - With respect to Community Directors and Physician Directors, Penn Medicine appoints from slates nominated by the Foundation
    - Post-Transition Period
      - Penn Medicine appoints all of the Directors
    - Chair must be a Community Director

- Governance of TCCHHS (cont’d)
  - Board authority and responsibilities
    - Board will have those fiduciary responsibilities not otherwise reserved to the University and Penn Medicine in the Amended and Restated Bylaws
    - Key powers of the Board
      - Approve any amendment to the Articles or Bylaws of TCCHHS or any TCCHHS affiliate by a 2/3 vote of all Directors
      - Approve any amendment to the Medical Staff Bylaws of TCCH
      - Approve, jointly with Penn Medicine, any new TCCHHS CEO
      - Develop and adopt a strategic plan for TCCHHS and TCCHHS affiliates consistent with Penn Medicine’s strategic plan
      - Recommend and approve new clinical services
      - Review and recommend operating and capital budgets
      - Physician credentialing and other requirements of the Joint Commission
Structure and Key Elements of the Transaction

Key Elements

- Governance of TCCHHS (cont’d)
  - Board authority and responsibilities (cont’d)
    - Key reserve powers of Penn Medicine
      - Approve any merger, consolidation, reorganization or dissolution of TCCHHS or any TCCHHS affiliate
      - Approve any amendment of the Articles and Bylaws of TCCHHS or any TCCHHS affiliate
      - Adopt the operating and capital budgets of TCCHHS and all TCCHHS affiliates
      - Approve long-term or material agreements
      - Approve the creation, acquisition, merger or dissolution of any subsidiary or affiliate entity
      - Approve new clinical services or discontinuation or consolidation of any clinical service
      - Approve strategic plans of TCCHHS and any TCCHHS affiliate
      - Appointment or removal of the President/CEO, Chief Operating Officer, and Board Chair

- Governance of TCCH and other TCCHHS affiliates
  - The Directors on the TCCHHS Board will serve as the TCCH Board
  - The Chair of the TCCHHS Board will serve as the Chair of the TCCH Board
  - The governance structure of the TCCHHS affiliates will be modified after Closing as directed by Penn Medicine
Structure and Key Elements of the Transaction

Key Elements

- Participation in Penn Medicine governance
  - Representation on the Penn Medicine Board
    - During the initial 10 year period –
      - the TCCHHS Board Chair will be an ex officio voting member of the Penn Medicine Board
      - Penn Medicine will appoint one additional Community Director or Physician Director on the TCCHHS Board to be a voting member of the Penn Medicine Board from a slate nominated by the Foundation
  - Representation on the Penn Medicine Executive Committee
    - During the initial 10 year period, the Chair of the TCCHHS Board will serve as a voting member of the Penn Medicine Executive Committee

- Post-Closing covenants of the University and Penn Medicine
  - Quality, safety, and patient satisfaction
  - Capital commitments
    - Specific amount for capital improvements during the first 5 years
    - Fully fund depreciation during second 5 years
    - Extreme Adverse Consequence may delay initial capital improvements
  - Prohibitions on change of control or asset sale
    - No change of control or asset sale of TCCHHS or any TCCHHS affiliate for 10 years after Closing
  - Acute care hospital and essential programs
    - Maintain TCCH as acute care hospital and certain essential programs for 10 years after Closing
    - Certain financial and quality exceptions to the covenant regarding essential programs
  - Charity care and community obligations
  - Medical staff matters
    - Maintenance of a community-based, open medical staff structure
    - No requirement that physicians become employed by UPHS
Structure and Key Elements of the Transaction
Key Elements

- Post-Closing covenants of the University and Penn Medicine (cont’d)
  - Employees of TCCHHS and TCCHHS affiliates
    - No material decrease in wages or benefits for at least 12 months after Closing
    - Best efforts not to terminate any employee for at least 12 months after Closing, except for cause or to realize efficiencies contemplated by the transaction
  - Residency programs
    - Maintain and support TCCH’s current residency programs and will seek to expand residency programs in a reasonable manner
  - TCCHHS name
    - For at least 10 years, prominently include the name “The Chester County Hospital” for the hospital and in conjunction with services provided by TCCH

- Limitations on the post-Closing covenants
  - In lieu of indemnification by the Foundation
  - If Indemnifiable Losses exceed a specified amount, then Penn Medicine’s capital commitments will be reduced by the excess amount
  - If Indemnifiable Losses exceed a specified amount over the initial 10 year period, then Penn Medicine will be relieved of other post-Closing covenants, including the prohibition on change of control or asset sale and maintenance of acute care hospital and essential programs
Structure and Key Elements of the Transaction

Key Elements

- Continuing role of the Foundation
  - Mission
    - Exclusively to support TCCHHS and TCCHHS affiliates as members of UPHS
  - Amended and Restated Articles of Incorporation and Bylaws
    - Purposes of the Foundation will be to support TCCHHS and TCCH as members of UPHS
  - Penn Medicine representation on the Foundation Board
    - Penn Medicine will appoint one trustee
    - Subject to recusal when the Foundation Board considers matters relating to compliance with or enforcement of the Affiliation Agreement
  - Enforcement of post-Closing covenants
  - Fundraising and investment activities
    - Must be reasonably consistent with activities and policies of UPHS
  - Use of existing funds and funds received post-Closing
    - The Foundation retained a specified amount of unrestricted funds
    - All other funds were transferred to TCCH on or before Closing
    - Future funds must be used to support TCCHHS and TCCHHS affiliates

Lessons Learned
Lessons Learned

- Benefits of a competitive process
- Use of a special transaction committee with appropriate representation from the Boards of the subject organizations and physician leaders
- Importance of the organizational and decision-making structure of the academic medical center
  - Single strategic vision
  - Unified governance and coordinated management and operations
  - Reduces execution risk, possibilities of delays, and misunderstandings
- Protections against diversion of patients to the academic medical center
  - Financial integration of the entire clinical enterprise
  - Substantial investment in the community hospital and its services
  - Meaningful enforceable post-Closing covenants

Lessons Learned

- Cultural compatibility
- Prior relationship and clinical arrangements
- Involvement of physicians in the process
- Physicians’ familiarity and comfort with the academic medical center, its leadership, and clinicians
- Importance of pre-transaction diligence and compliance matters