

DANIEL E. LUNGREN  
Attorney General

State of California  
DEPARTMENT OF JUSTICE



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November 8, 1996

John F. Walker, Jr.  
Latham & Watkins  
633 West 5th St., Suite 4000  
Los Angeles, CA 90071-2007

Re: San Diego Hospital Assn., et al. ("Sharp")

Dear Mr. Walker:

This is to acknowledge receipt of the materials forwarded to us on November 7, 1996 -- we will, without delay, begin the process of checking them for completeness. As I indicated in our recent conversation, we have now finished our review of the original submission (dated August 16, 1996) and have made substantial progress in analyzing the materials provided to us on October 25, 1996.

Pursuant to our understanding with Sharp, and as confirmed in Carlisle Lewis' June 26, 1996 letter to me, Sharp has agreed to provide the Office of the Attorney General with adequate time to review this transaction, notwithstanding the 20 day period provided by Corporations Code section 5913. Moreover, it was understood that the review process would take approximately 60 days from receipt of the necessary documents. Per our recent telephone conversation, and as confirmed by my letter to you of October 25, 1996, section 5913 notice is deemed to have occurred effective November 8, 1996, assuming the completeness of the materials received today.

While we will, of course, need to complete our review and analysis of all of the submitted materials, we have nonetheless reached certain conclusions based on the review conducted to date. Because of the time pressures created by the desired year-end closing and because these conclusions significantly impact the transaction, we felt it only fair to apprise you of them at this time. Were we to wait for the full time anticipated in order to complete our review prior to bringing these issues to your attention, there would, quite frankly, be insufficient time left for you to respond. This seems to us inconsistent with the spirit of cooperation and candor with which we have been dealing. For clarity's sake, we have dealt with the key issues separately below. I would, however, expect that additional issues might

arise from our ongoing review of the recently submitted documents.

1) Sharp Memorial Hospital-Sharp Cabrillo Hospital

The Articles of Incorporation of both of these hospitals (now combined) define the charitable trust on which their assets are held. Those articles require that the assets of these two hospitals be used solely for the purpose of "acquir(ing) and operat(ing) a non-profit charitable hospital and medical center in the City of San Diego..." Moreover, those articles of incorporation specifically prohibit any activities not in furtherance of those specific purposes, except to an insubstantial degree.

In our view, the transfer of these hospitals into the for-profit LLC constitutes an abandonment and breach of that trust. While it is our opinion that the directors of those hospitals are permitted, pursuant to Corporations Code section 5911, to sell all or substantially all of the assets of the hospitals--the proceeds of any such sale are required to be used for the same charitable purposes. (See Queen of Angels v. Younger (1977) 66 Cal.App.3d 359; Holt v. College of Osteopathic Physicians & Surgeons (1964) 61 Cal.2d 750.

Since, post closing, your charitable foundation will not be operating any non-profit hospital within the City of San Diego and since the sale and contribution agreement and LLC agreement, by their express terms, do not permit the removal of the sale proceeds attributable to these hospitals from the joint venture, nor their transfer to another non-profit hospital within the City of San Diego or other entity providing such services, the inclusion of these hospitals within the transaction constitutes, in our view, a breach of trust.

Moreover, our review of the materials provided to date, and confirmed by interviews with Board members of Sharp Memorial Hospital, indicates that these issues were never presented to, nor considered by, that Board prior to its approving this transaction.

The Sharp Memorial Hospital Board is an independent Board of Directors of a non-profit corporation that itself is separate and distinct from SDHA. That Board of Directors owes a fiduciary

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The assets of these hospitals constitute a significant portion of the Sharp value -- contributing a fund balance of approximately \$170 million (61% of the Sharp total) and operating income of \$1.3 million per year, compared to a loss of approximately \$6 million in the system as a whole.

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duty of loyalty and due care to Sharp Memorial Hospital and its failure to address these issues and to comply with charitable trust law constitutes, in our view, a breach of that duty.

2) Undervaluation of the Charitable Assets

It seems clear from a review of the documents provided to us that in order to meet their fiduciary obligations, the Sharp directors will be compelled to exercise the "put" option and to do so almost immediately. This conclusion is confirmed by virtually all of the available information, including:

a) Sharp's own analysis that confirms that the put's value is highest if exercised immediately and that holding it for any substantial time before exercising it results in a significant loss of charitable assets, e.g. exercising it at the end of the three-year period causes a loss of charitable value in the amount of \$57.7 million (a loss of 29% of its total value);

b) The LLC membership interest is, by its express terms, virtually unmarketable (except at an enormous discount) after the expiration of the "put" term -- thereby prohibiting fiduciaries from holding it past that date;

c) Sharp's planned borrowing of \$50 million dollars, secured by the assignment of the put option to the lender, will necessitate the exercise of that option as there is no adequate source of funds to repay that loan except the exercise of the option;<sup>2/</sup> and

d) Sharp's own projections show that the income to be generated by the LLC is substantially less than would be generated by any reasonable diversified investment portfolio, with the guaranteed amount being less than the one year T-bill rate.

As such, it is clear that in order to meet their fiduciary obligations to the charitable beneficiaries, the Sharp Board will be required to exercise the put at its initial price, i.e. \$202 million. This is the price that Columbia is, in fact, paying for the Sharp assets.

However, our review indicates that this sale price is over \$109 million less than the amount offered by Tenet Healthcare and over \$200 million less than the amount apparently offered by

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2. Sharp's own projections indicate that the income to be generated by the LLC is insufficient to repay the loan thereby necessitating the use of the put option funds.

ORNDA -- resulting in a loss of one-third to one-half of the equity value of the Sharp system.

This enormous price differential is made even worse by the presence of additional financial benefits within the non-Columbia deals, including higher opening cash balances for the Foundation, better cash flows, and opportunities to share in capital appreciation. These factors require us to conclude that the Sharp Board's acceptance of the Columbia proposal represents a serious breach of trust which will cost the charity's public beneficiaries between \$100-\$200 million. Should this deal close in the proposed form, we will seek to hold the Sharp directors who voted to approve the transaction personally liable for this amount.

3) Lack of Due Diligence

We are, in addition, particularly concerned that the Boards of Directors of SDHA and the affiliated corporations voted to approve the transaction without knowledge of, or resolution of, a number of key matters which will have a material financial effect on the charitable assets. This appears to us to be in direct contravention of the Board members' duties of due care after reasonable inquiry.

Among the key unresolved matters which materially effect the transaction are the following:

- a) the failure to determine the financial effect of the Medicare/Medicaid recapture liability given the inevitability of exercising the put option;
- b) the failure to obtain, or even seek, IRS rulings on the issues of Sharp's ongoing status as a public charity as distinguished from a private foundation and the potential subjection of Sharp's joint venture income to UBIT;
- c) the failure to identify the excluded liabilities not being assumed by the joint venture;
- d) the failure to consider what effect changes in the initial RFP (re inclusion of the Ross Stealy Medical Group & Grossmont Hospital in the transaction) would have had on potential alternative bidders;
- e) the failure to consider the charitable trust issues posed by Queen of Angels and Holt; and
- f) the failure to explore the alternative of outright sale of all of the assets to either a for-profit or non-profit entity in lieu of the joint venture proposal.

4. Imprudent Investment

Were one to assume this to be a real joint venture proposal, it would, in our view, raise serious issues of imprudent investment. We doubt that it is ever prudent for a non-profit public benefit corporation to invest virtually all of its assets in a single investment, let alone an LLC in which it is not the managing partner, which has virtually no capital appreciation potential, which is virtually unmarketable after three years, and which yields a return which the charity itself projects at well below the expected rate of return for a properly-managed portfolio.

If we are correct in assuming the inevitability of the immediate exercise of the "put" option, these concerns become moot. Were the Sharp Board to retain its interest in the joint venture, however, they would become relevant.

5) Process Concerns

In the course of our review, we have become concerned over whether the actual process was managed in a way to allow the free market to work or whether there was a bias in the process to favor one party over others. Given our analysis of the relative values of the rejected proposals compared to that of the accepted proposal, those concerns are magnified. In addition, our preliminary inquiry indicates that essential information necessary to the proper review of this transaction was denied to certain members of the SDHA and affiliated corporation Boards of Directors, notwithstanding their request for such. In our view, this creates serious issues regarding possible breaches of trust.

As such, the Attorney General has authorized a Government Code section 11180 investigation into this transaction (I have attached a copy of the authorization for your information). We are desirous of taking statements under oath, at a mutually agreeable time, from the members of the Sharp Special Committee and from the Shattuck Hammond investment bankers who worked on this transaction. Please advise me if you will make these individuals available voluntarily or whether it will be necessary to subpoena them.

As we discussed in our recent telephone conversation, we are available to meet with you to discuss these issues. In the interim, however, the time pressures inherent in the statutory scheme create some difficulties. As such, we have prepared a "standstill agreement" and enclosed it herewith. If it is acceptable to you, we are prepared to delay initiating legal action while discussions take place. To do so, we will need to have the agreement signed by November 15, 1996. Should the

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standstill agreement not be signed by November 15, 1996, we will initiate legal proceedings in order to protect the public's interest in these assets.

Sincerely,

DANIEL E. LUNGREN  
Attorney General

JAMES R. SCHWARTZ  
Deputy Attorney General

JRS:mdm

cc: Carlisle C. Lewis, III

DANIEL E. LUNGREN  
Attorney General

State of California  
DEPARTMENT OF JUSTICE



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November 8, 1996

John F. Walker, Jr., Esq.  
Latham & Watkins  
633 W. Fifth Street, Suite 4000  
Los Angeles, CA 90071-2007

RE: Notice of Pending Transaction Involving The San Diego  
Hospital Association and Certain Affiliated Corporations

Dear Mr. Walker:

This letter will constitute the agreement (the "Standstill Agreement") between The San Diego Hospital Association and its affiliated corporations (hereafter collectively referred to as "Sharp"), and the California Attorney General (the "AG") governing the conditions under which the proposed transaction between Sharp and Columbia/HCA, which is the subject of that letter dated August 16, 1996 from counsel for Sharp to James R. Schwartz, Deputy Attorney General, will proceed.

#### RECITALS

A. Sharp and Columbia have entered into a Contribution and Sale Agreement (the "Sale Agreement") under which they agree to the terms of a proposed Amended and Restated Operating Agreement (the "Operating Agreement") and an Option To Sell Agreement (the "Option Agreement"). Collectively these agreements comprise the Transaction Agreements.

B. On August 16, 1996, Sharp advised the AG in writing of the proposed transaction and provided certain materials in explanation thereof.

~~DANIEL E. LUNGREN~~ On September 4, 1996, the AG sent to Sharp a request for additional information determined to be necessary in order to complete his review of the Proposed Transaction.

D. On October 24, 1996, Sharp responded to the AG's request for additional information by providing a significant amount of the information responsive to the AG's requests. On November 7, 1996, Sharp provided what it represents to be the balance of the information requested by the AG. The AG has acknowledged that upon receipt of all of the materials he

requested in his September 4, 1996 letter to Sharp's counsel, notice to the AG of the Sharp/Columbia transaction, pursuant to Government Code section 5913, would be deemed effective.

E. The AG has reviewed much of the material provided by Sharp in response to these requests as well as the information provided with Sharp's initial submission of the proposed transaction. In addition the AG has interviewed various persons concerning facts relevant to the proposed transaction. The AG has not yet completed his final review of the voluminous materials provided by Sharp or his review of the proposed transaction and the Transaction Agreements.

F. The AG has informed Sharp that he has serious questions concerning a number of issues involved in the Transaction Agreements and the proposed transaction.

NOW, THEREFORE the AG and Sharp agree as follows:

1. Sharp will not close the proposed transaction under the terms of the Sale Agreement, nor otherwise sell, lease, convey, exchange, transfer or otherwise dispose of all or substantially all of its assets without the prior written consent of the AG.

2. Sharp will not take any steps to implement any provisions of the Sale Agreement, the Operating Agreement or the Option Agreement without the prior written consent of the AG, except such steps that Sharp may be required to take under the provisions of any applicable state or federal law, e.g., the required Hart-Scott-Rodino procedures, and such steps as may be necessary under the provisions of section 7.4 of the Sale Agreement relating to securing approval of the proposed transaction by the AG. If Sharp decides that it wishes to implement any other provision of the Sale Agreement, the Operating Agreement or the Option Agreement prior to the completion of the AG's review, Sharp shall give the AG fifteen (15) days written notice of its intention to implement any provision of any of those agreements.

3. The AG will not institute any civil action in any court seeking injunctive relief to prohibit the closing, or implementation of the provisions, of the proposed transaction prior to receiving a notice under the terms of paragraph 2 of this Standstill Agreement, unless he has provided ten (10) days written notice to Sharp of his intention to seek such relief.

4. This agreement may be terminated by either party provided that fifteen days prior written notice has been given in the manner required by paragraph five of this agreement.



5. Any notice required or permitted under this Standstill Agreement shall be deemed effective when personally delivered, when received by facsimile transmission or other electronic means, including telegraph and telex, when delivered by overnight courier, or five (5) days after being deposited in the United States mail, with adequate postage prepaid thereon, certified or registered mail, return receipt requested, in any event addressed as follows:

AG

James R. Schwartz  
Deputy Attorney General  
Department of Justice  
Attorney General's Office  
50 Fremont Street, Suite 300  
San Francisco, CA 94105  
Facsimile: (415) 356-6257

with a copy to:

H. Chester Horn, Jr.  
Deputy Attorney General  
California Department of Justice  
300 South Spring Street, Suite 500  
Los Angeles, CA 90013  
Facsimile: (213) 897-2808

Sharp

San Diego Hospital Association  
3131 Berger Avenue, Suite 100  
San Diego, CA 92123  
Attn.: Carlisle C. Lewis, III  
General Counsel  
Facsimile: (619) 541-4065

with a copy to:

John F. Walker, Jr.  
Latham & Watkins  
633 West Fifth Street, Suite 4000  
Los Angeles, CA 90071-2007  
Facsimile: (213) 891-8763

or to such other address or number, or to the attention of such other person, as any party may designate, at any time, in writing in conformity with these notice provisions.

IN WITNESS WHEREOF, the parties hereto have caused this Standstill Agreement to be executed in multiple originals by their authorized officers or representatives to be effective as of November 15, 1996.

DANIEL E. LUNGEN, ATTORNEY GENERAL

SAN DIEGO HOSPITAL  
ASSOCIATION AND ITS  
AFFILIATED CORPORATIONS

By:   
James R. Schwartz  
Deputy Attorney General

By: \_\_\_\_\_

1 STATE OF CALIFORNIA  
2 DEPARTMENT OF JUSTICE  
3 OFFICE OF THE ATTORNEY GENERAL

4 Delegation of Authority to Conduct Investigation

5 Pursuant to the provisions of section 11182 of the  
6 Government Code of the State of California, I hereby authorize  
7 Carole Kornblum, Assistant Attorney General; James R. Schwartz  
8 and H. Chester Horn, Jr., Deputy Attorneys General, and the  
9 attorneys and/or auditors assigned to the Charitable Trust  
10 Section, and each of them, and any expert consultants retained by  
11 them, to conduct an investigation into the business activities  
12 and affairs of San Diego Hospital Association, a charitable  
13 corporation and its affiliates including, but not limited to,  
14 Sharp Memorial Hospital, Sharp Cabrillo Hospital, Sharp Chula  
15 Vista Medical Center, Sharp Temecula Valley and Sharp Mission  
16 Park, and the officers, directors and employees of such.  
(collectively referred to hereafter as "Sharp"). Carole

17 Kornblum, James R. Schwartz, H. Chester Horn, Jr., and the  
18 attorneys and auditors assigned to the Charitable Trust Section  
19 are authorized to issue subpoenas, inspect books and records,  
20 hear complaints, take testimony and administer oaths in  
21 connection therewith as they deem necessary. Any expert  
22 consultants retained by them are authorized to inspect books and  
23 records and hear complaints in this matter.

24 In connection therewith, I delegate to the said Carole  
25 Kornblum, James R. Schwartz, H. Chester Horn, Jr., and the  
26 attorneys and auditors assigned to the Charitable Trust Section,  
27 the powers conferred upon me by Government Code sections 11180

1 and 11181. This delegation is not exclusive, and additional  
2 delegations may be made to other persons in this and other  
3 matters.

4 Such investigation concerns matters relating to subjects  
5 under the jurisdiction of the Department of Justice and the  
6 Office of the Attorney General.

7 Dated: November 4, 1996

8 *Daniel E. Lungren by*  
9 *Dave Stirling, Chief Deputy*  
10 DANIEL E. LUNGREN  
11 Attorney General of the  
12 State of California  
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