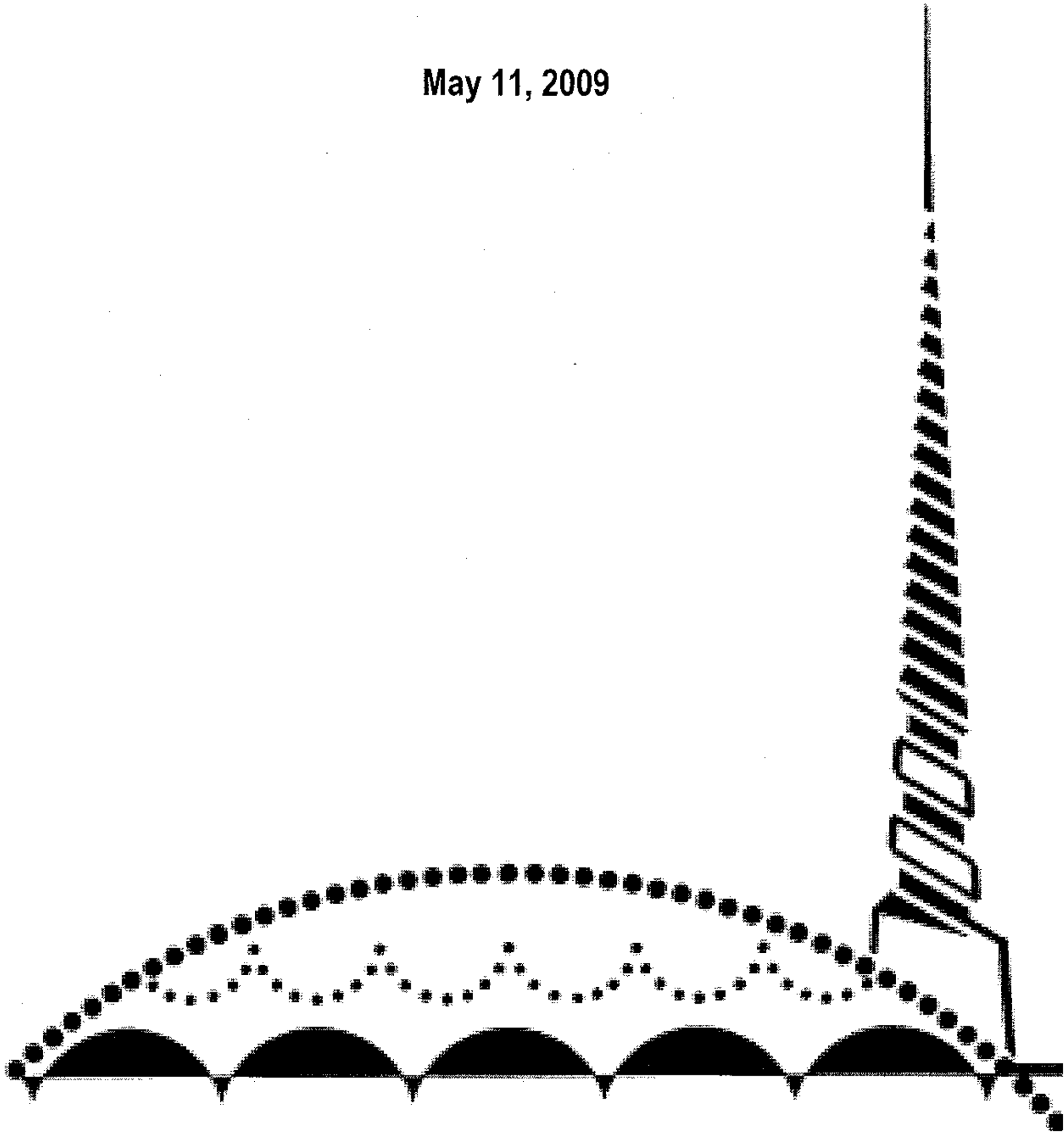
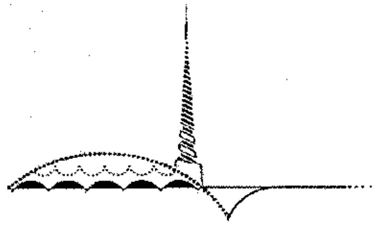
2008-2009 MARIN COUNTY CIVIL GRAND JURY

Marin General Hospital: Hope is not a strategy

May 11, 2009





Marin County Civil Grand Jury

SUMMARY

Few institutions are as important to Marin County as Marin General Hospital. It is the county's designated Level III trauma center; it is the primary provider of mandated safety net services for the needy; it is the home of state-of-the-art facilities in cardiology, oncology and other programs; it is the only provider of labor, delivery and maternity services in the county; and it is the hospital of choice for tens of thousands of Marin County residents. Yet the future of the hospital is not secure.

Within the past four years the hospital's prospects have been transformed in a series of decisions by the Marin Healthcare District, which owns the hospital. The District Board rejected an offer by Sutter Health, which currently operates the hospital under a lease with the Healthcare District, to build a new wing to comply with mandated seismic safety standards in exchange for a new 30-year lease. It also negotiated a termination of the controversial lease and is now scheduled to take back management of the hospital on June 29, 2010. The hospital, which is functioning well, is at risk.

The Grand Jury has grave doubts about the wisdom of the District Board's chosen course of action, especially under the extremely difficult economic conditions prevailing today. The board's plan woefully underestimates its working capital needs, assumes the public will vote to tax itself for a new wing estimated to cost between $350 million and $400 million, and implausibly takes for granted that it will be able to negotiate reimbursements from insurance companies as favorable as those negotiated by large healthcare systems. Even some board members have expressed doubts about the long-term success of the hospital. Some have expressed publicly the fear that the hospital will eventually end up a small county hospital mainly providing limited safety net services. Thus, failure is a real possibility. But for the District Board that seems to be the lesser of two evils, with Sutter the greater evil.

Leadership requires more than crossing your fingers and hoping that everything will work out. Good intentions are not enough to preserve this precious asset. Hope is not a strategy.

Most hospital experts interviewed by the Grand Jury expressed serious reservations about the likelihood of success of a stand-alone public hospital in today's complex and demanding competitive environment. Hospital systems such as Sutter have substantially greater access to the capital needed to fund expensive new equipment and technology, as well as the resources to attract and recruit increasingly scarce doctors, nurses and technical staff. A stand-alone public hospital, on the other hand, must generally obtain its financing through revenue and general obligation bonds requiring approval of two-thirds of the electorate, and it is not in a position to offer the array of attractive programs to

doctors, nurses and technical staff that the larger hospital systems provide. It also is vulnerable to competitive pressures from outpatient surgery and diagnostic centers.

A hospital with the history and reputation of discord that haunts the Marin Healthcare District is at an even greater disadvantage. The Healthcare District's consultant, Kurt Salmon Associates (KSA), which determined that the hospital could survive as a stand-alone hospital, cautioned that it is essential that it be operated out of public view in order to avoid the political turmoil that still arises at District Board meetings and that has unnerved doctors and staff. Some vocal members of the community, however, object to such a structure. Such opposition, together with the fact that more than 40 percent of Marin's population are members of the Kaiser Permanente health system and scores more obtain their medical care from San Francisco hospitals, may be sufficient to defeat passage of a $350 million to $400 million bond measure required to fund construction of a new hospital wing to comply with seismic safety standards.

The ongoing financial needs of the hospital are equally daunting. Operation of today's hospital requires staggering sums of cash. Marin General's expenses amount to $800,000 to $1 million *per day*, and insurance reimbursements for patient care can be slow in coming. Prudent management, not to mention industry standards, dictates that a hospital have cash on hand equal to at least 100 days of expenses as a cushion for unexpected delays in collecting accounts receivables. An example of how such emergencies can arise is the state's announcement earlier this year that MediCal would be paying its bills in the form of IOUs rather than cash until the state budget crisis was resolved. Marin General should have on hand at least $100 million in working capital alone, plus capital to fund emergencies, capital and equipment expenditures, and long-term construction needs. The Healthcare District's current plan, however, assumes that the hospital will operate with *at most* $20 million in cash on hand, less than 25 percent of the amount considered prudent. And most of that cash will have to be borrowed.

The Healthcare District hopes to borrow $15 million in working capital by the time it takes control of the hospital, but the availability of this sum is by no means assured. The current recession has led to a dramatic credit crunch, and even strong businesses have found it nearly impossible to obtain financing. Hospitals have been particularly hard hit and most have had to pay much higher interest rates than usual. This does not bode well for the planned bond measure to raise $350 million to $400 million to pay for a new, seismically safe hospital wing to comply with state mandates. The higher interest expense will cost taxpayers tens of millions of dollars.

The seriousness of the financial situation is exacerbated by the reluctance of lenders to deal with the Healthcare District because of the perceived instability of the board. While the board has in recent years made progress in bringing meetings under control, the criticism continues to be sharp and threatening from those opposed to board policies. The realignment of the board every two years through hard-fought elections also gives rise to fears of instability. These concerns of volatility extend to the medical professionals who work at the hospital. Some have expressed grave concern about the

ongoing steadiness and reliability of leadership, as well as the availability of sufficient financing, once Sutter Health is no longer operating the hospital.

The Grand Jury is impressed with the dedication of the directors of the Marin Healthcare District and their loyalty to, and justifiable pride in, Marin General. It is the Grand Jury's view, however, that the hospital should not be publicly owned and privately managed, but rather should be transferred to a financially strong healthcare system, such as Sutter Health, to be professionally managed with appropriate commitments to carry on the services Marin General has provided and to comply with mandated seismic safety standards. Such a plan would require the approval of a majority of the electorate of the district. The people of the district should have an opportunity to decide whether this important community asset should operate as a stand-alone hospital with local oversight or as a private hospital managed by a financially strong non-profit health system such as Sutter Health.

BACKGROUND

The Marin County Civil Grand Jury has produced eight reports on the Marin Healthcare District and the hospital over the past 12 years. Most recently, the Grand Jury issued a series of reports over the two-year period 2003-2005. These reports presented, in detail, the history of the hospital, beginning with the formation of the Marin Healthcare District in the late 1940s through the lease of the hospital to Marin General Hospital Corporation in 1985, and the eventual control of the hospital by Sutter Health. The reports also described the paralyzing political bickering that, at its height, resulted in out-of-control District Board meetings lasting well into the night.

Since the publication of those reports, much has changed and the Healthcare District is poised to retake control of the hospital on June 29, 2010. Under the circumstances, it is appropriate for the Grand Jury once again to assess the stewardship of this important community institution.

METHODOLOGY

In preparing this report the Grand Jury interviewed members of the Healthcare District Board of Directors, employees of the district and of the hospital, doctors associated with the hospital, an expert on the formation and dissolution of local governmental agencies, members of the Marin County Board of Supervisors, county employees, experts in the field of healthcare issues, and knowledgeable local citizens. Members of the Grand Jury also attended public meetings of the Marin Healthcare District Board of Directors and its Finance Committee, and reviewed the settlement and transfer agreements, the report prepared by the district's consultant, the Abaris Report prepared for the county regarding safety net services for the needy, and numerous publications and websites.

DISCUSSION

What is a healthcare district?

In 1945 the California Legislature responded to a need for community hospitals after World War II by adopting legislation permitting communities to form local healthcare districts, complete with elected local governing boards and the authority to impose property taxation, to build and maintain hospitals and other healthcare facilities and improve healthcare in their communities. More than 70 such districts have been formed, most with hospitals and most located in rural communities. Several such hospitals are located in the Bay Area, including Marin General, El Camino Hospital in Mountain View and Washington Hospital in Fremont.

Marin General opened in 1952 after the Marin Healthcare District was formed and issued the necessary bonds to construct the hospital. For many years the hospital operated profitably, so much so that in the early 1970s the district chose to cease levying taxes on property within its borders, which includes all of Marin County except Novato. As a result, with the passage of Proposition 13 in 1978, the district is now prohibited from levying property taxes on its constituents without an affirmative two-thirds vote of the electorate.

Why doesn't the Marin Healthcare District operate Marin General?

In 1985 the Healthcare District entered into a 30-year lease of the hospital with Marin General Hospital Corporation, a nonprofit corporation formed by the district's then general counsel and the hospital's chief executive officer. Under the terms of the lease, the Marin General Hospital Corporation received the hospital's cash, accounts receivables and a lease of the premises for the lease term in return for an annual lease payment equal to $1,500,000, payable by $125,000 in cash and the balance in capital improvements to the hospital equal to at least $1,375,000. Shortly after entering into the lease, Marin General Hospital Corporation affiliated with California Healthcare Systems, comprised of Mills-Peninsula Hospital and Pacific Presbyterian Hospital in San Francisco (now California Pacific Medical Center). In 1996, California Healthcare Systems and Sutter Health merged, and Sutter took control of Marin General Hospital Corporation.

The lease was controversial from its inception. Critics derided what they considered to be its unfavorable terms, including the perceived paltry size of the lease payments and the lack of oversight or control by the district over the quality of medical services provided by the hospital. The lease led to legislation that requires any such transfer now to be approved by the electorate. Lawsuits have challenged the lease as well as the affiliation with Sutter. District Board members have faced recall elections. Sutter has been routinely demonized, accused by critics of providing poor patient care and siphoning money generated at Marin General Hospital to use elsewhere in the Sutter system. It has also been criticized for charging too much.

The quarreling often spilled over to the meetings of the Marin Healthcare Board of Directors. These meetings were lengthy and sometimes raucous and led some to characterize the District Board as dysfunctional. In recent years board meetings have become more civil, with limited speaking times for the public and generally respectful colloquy among board members. Serious disagreements remain, however, particularly between the board and outspoken members of the public, as well as between board members themselves. Elections every two years for board seats are expensive, hard fought and acrimonious.

Lost in the battle is the high quality of the hospital itself, which has been commended by oversight agencies for the caliber of its programs. Its cardiac unit has an up-to-date catheterization laboratory and has some of the best response times for treatment of blocked arteries among California hospitals. Its oncology department has state-of-the-art CT scanners, together with two linear accelerators that are the most advanced in California, and has received a commendation from the American College of Surgeons. The hospital has a neonatology intensive care unit, unusual for a hospital of its size. Its intensive care unit has a dedicated staff of doctors and nurses, supplemented by remote monitoring at a San Francisco site, which enables physicians and nurses in Marin to consult with other specialists as needed.

The trauma unit, which has both a trauma team and a backup trauma team on call at all times, is also highly regarded. While categorized as Level III, it has some of the characteristics of the higher Level II trauma center because it has a neurosurgeon on call at all times. The emergency room treats over 36,000 patients annually. The hospital also serves the safety net population, providing delivery, trauma, psychiatric and other medical care to those on MediCal, CalKids or who are otherwise under-insured or uninsured. According to the Abaris Report, between 17.6 percent and 38 percent of the county population falls within the definition of the safety net population, and two-thirds of them use Marin General.

The lease between the Healthcare District and Sutter is terminated

A long-simmering dispute over whose responsibility it was to retrofit the hospital to comply with seismic standards boiled over in 2005. Under current law, the hospital must comply with the standards by 2013. Sutter offered to build a new wing to the hospital that would comply with the seismic standards, but it wanted a new 30-year lease in return. The District Board, however, insisted that the lease required Sutter to comply with the seismic standards without an extension. Sutter filed a lawsuit against the district seeking a declaration that it was not required to incur the expense of retrofitting the hospital. The district countered with its own suit seeking the opposite judgment. Negotiations resulted in a settlement agreement whereby Sutter agreed to terminate the lease no later than July 1, 2010 and the district agreed to shoulder all of the retrofit obligations.

The settlement agreement requires Sutter to notify the Healthcare District at least one year in advance of the date it intends to terminate the lease and turn the hospital back to the district. This date is called the transfer date. On March 11, 2009 Sutter notified the Healthcare District that the transfer date would be June 29, 2010. Beginning one year before the transfer date, or June 29, 2009, Sutter must give the district financial and other information about the operation of the hospital in order to permit it to plan effectively for the transition to district control. Until that time, the district has limited access to key hospital operating data and is restricted in its ability to communicate with hospital staff.

Relations between the district and Sutter remain rocky. While the concept of a transition would seem to require cooperation between the parties, instead the bickering continues. At one point, the court ordered the parties not to disclose to the public communications they had with each other. Members of the Marin County Board of Supervisors, with court approval, have acted as an informal go-between to facilitate communication between the parties. Recently the Alliance to Save Our Hospital, a local advocacy group, has pleaded with both Sutter and the district to adopt a more cooperative attitude.

Preparing for transition to district control

Once the district agreed to terminate the relationship with Sutter, it hired consulting firm Kurt Salmon Associates, known as KSA, to assist it in making plans to take control of the hospital. Several sources told the Grand Jury that the first choice of some directors was to find another hospital system to replace Sutter and to manage the hospital. Well-known systems, including UCSF, Mayo Clinic, Tenet, Catholic Healthcare West and others were canvassed to gauge their level of interest in running Marin General. To the surprise of many, no hospital system was interested. According to Grand Jury sources, a key factor was the reluctance of other hospital systems to deal with the politically charged nature of the Marin Healthcare District. Another factor was the large capital investment required to comply with seismic safety standards.

At that point, KSA was asked to evaluate whether Marin General could be run profitably as a stand-alone hospital, that is, a hospital not affiliated with other hospitals in a healthcare system. In September 2007, KSA presented its report to the Healthcare District Board. The report concluded Marin General could survive as a stand-alone hospital under district control only if the district achieved certain objectives in the time remaining before the transfer date. These objectives included:

- Obtain working-capital financing to fund the transition tasks and to fund ongoing hospital operations after the transfer date.

- Prepare for mandated seismic upgrades and simultaneously seek to delay the deadline for compliance.

- Create a hospital management system insulated from political controversy; this has sometimes been described as a "firewall" operating board that would make day-to-day decisions free of public scrutiny.

- Develop an information technology (IT) system to replace the existing hospital information system, since Sutter will remove its current system on the transfer date.
- Hire a management team to oversee the transition.

The District Board has followed KSA's recommendations and has taken the following actions:

- Obtained a $20 million line of credit from the County of Marin to finance transition expenses, to be repaid in full within 45 days of the transfer date. The district CEO was unable to obtain financing from conventional sources, even though he reportedly applied to at least 20 institutions. Financing for the post-transfer date period has not been obtained, although the district has retained an investment-banking firm to attempt to arrange it.
- Filed timely construction plans for a hospital seismic retrofit in 2013. Efforts to delay the compliance date have so far been unsuccessful. There is a bill pending in the Assembly to grant Marin General a two-year extension to comply with SB 1953, the law requiring hospitals to meet seismic safety standards.
- Authorized KSA to develop proposed bylaws of an affiliated subsidiary corporation that would manage the day-to day operations of the hospital outside the public spotlight.
- Entered into a contract with ACS Healthcare Solutions to develop a state-of-the-art information technology system for Marin General at a cost of $57 million.
- Hired a chief executive officer to oversee the transition, retained a hospital management company to provide financial management services for the transition effort and formed a Transition Advisory Committee comprised of industry and community leaders to advise the CEO.

During District Board meetings the directors have considered key elements of the KSA plan in a methodical manner, and the district seems to be on track for accomplishing many of the required objectives. Performance of these tasks will cost more than $20 million by the transfer date. The source of funds is the loan from the county, scheduled lease payments from Sutter, and approximately $3.5 million advanced from Sutter as part of the settlement agreement, half of which must be repaid, with interest, after the transfer date. The district is also considering using all or a portion of $5 million currently held by the Marin General Foundation to pay for architectural and design fees for the new wing.

Even though the District Board is implementing the KSA plan, some directors are uneasy with the hospital's future prospects. Some expressed the opinion that in the long run the hospital will not be able to compete successfully with regional hospital systems, and may become a county hospital primarily providing emergency and safety net services. Other

board members expressed concern that outpatient facilities will proliferate and adversely affect the hospital's profitability. One Grand Jury source stated that "outpatient surgeries are way down" at the hospital and attributed this to the private facilities operated by doctors.

Obstacles to success

Notwithstanding the progress that the district has made in implementing the transition plan, there are obstacles to success that the Grand Jury considers serious enough to urge the district to reconsider its strategy. Primary among them is the worldwide financial crisis, said to be the worst since the Great Depression, and the attendant credit freeze that have restricted the ability of all businesses, including hospitals, to raise capital.

Need for capital

Capital, and lots of it, is the lifeblood of a hospital, second only to the quality of its staff. It is needed for seismic construction costs, now estimated to be $2 million to $3 million *per bed*. It is needed for the acquisition and continual upgrading of technology. For example, Sutter estimates that it will spend over $1 billion to create its system-wide electronic medical records system. Capital is required for medical equipment, and there is a constant need to upgrade that equipment. In the past four years, Marin General has spent over $30 million on new medical equipment alone. Marin General needs money to fund its working capital and emergency reserves and to construct the hospital wing necessary to comply with state-mandated seismic safety upgrades at a cost of over $300 million.

It also needs capital to execute an effective strategy for competing with other hospitals in the area as well as physician-owned facilities. Already at least one-third of southern Marin residents choose San Francisco hospitals for their care and more than 40 percent of Marin residents belong to Kaiser. Marin General will need to add, on an ongoing basis, expensive technology and innovative services to those currently offered. For example, the hospital's cardiology doctors have requested new equipment costing $11 million. The Grand Jury worries that over the next several years, Marin General may be forced to forgo many of the capital investments needed to meet these competitive pressures because it will need to apply whatever positive operating margin it has to accumulating necessary capital reserves.

Marin General's most immediate need, once Sutter leaves and the district takes control, is for working-capital financing. This is financing needed to bridge the gap between the time the hospital is required to pay its employees and creditors and the time it receives the money owed by patients and their insurers.

Hospital industry experts whom the Grand Jury consulted, as well as industry publications, agree that as a rule hospitals need cash on hand equal to *at least* 100 days of expenses to assure that they will have a cushion against unexpected delays in payment of accounts receivables. In one example, MediCal announced earlier in the year that it

would be paying hospitals with IOUs instead of cash until the state's fiscal crisis was resolved. KSA estimates that 9 percent of Marin General's revenues are MediCal revenues, or approximately $25 million of the hospital's more than $280 million in revenues. A delay of several months could pose a hardship for an undercapitalized institution. As one industry publication states, "in the past decade, cash has become king—i.e., critical for funding operations and providing credit strength." Even in the difficult third quarter of 2008, another journal reports, the median days-cash-on-hand for U.S. hospitals was 110. Since Marin General Hospital expends $800,000 to $1 million per day, the industry standard dictates that the hospital have at least $100 million in cash on hand on its first day under district control. This does not include a cushion for unexpected expenses, nor does it include a reserve for capital and equipment expenditures or seismic retrofit.

The District Board has no plans to raise the money needed to have such cash reserve on hand at the transfer date. Rather, the maximum cash-on-hand contemplated, according to district officials, is less than 30 days of expenses. Indeed, according to the district's Cumulative Cash Flow Budget distributed to the Management, Finance and Audit Committee on April 20, 2009, while the hospital will have $21.45 million cash on hand on July 1, 2010, four months later its cash position will be reduced to $16.27 million. The cash reserves will come from two primary sources. Under the terms of the settlement agreement, Sutter is required to leave the hospital with $5 million in cash, and all "excess working capital" is to be transferred to Sutter. For the remainder, the district has retained Shattuck Hammond Partners, an investment-banking firm, to assist it in arranging financing. At a public meeting on February 10, 2009, the firm advised the board that it was working on a feasibility study to raise up to $50 million in financing. This financing would be deployed to repay the county's $20 million loan, to pay the district's IT consultant $15 million, and to provide $15 million for working capital needs.

The Grand Jury was told by representatives of the district that while 100 days of cash on hand may be desirable, such sums are simply not available to the hospital and the hospital can get by without them based on its operating history of collecting accounts receivables.

Not only is the amount of working-capital financing that the district plans to seek inadequate, there is the question of its availability. Also questionable is the district's ability to raise the $350 million to $400 million needed to construct the new wing required to meet mandated seismic safety standards. Paying for construction will require a bond issue approved by two-thirds of the district electorate. One expert told the Grand Jury that at present, "there is no bond financing available for hospitals." Shattuck Hammond addressed this issue at the public meeting, candidly acknowledging that the climate for financing hospitals has changed dramatically in the past 18 months. In mid-2007, a representative stated, financing at low rates was readily available to a wide range of hospitals. With the liquidity crisis in the summer of 2008, however, even good credit risks find it difficult to obtain financing, and what is available is much more costly. He opined that "markets are beginning to stabilize and access to credit is opening up," although at high interest rates, citing three hospitals that issued bonds since the recent

liquidity crisis, two with coupons over 8.25 percent and one, insured by FHA, paying 6.75 percent.

According to Shattuck Hammond's representative, the firm is "confident that [working capital] financing can be put in place" because the district will not need the funds for more than a year. The implication is that by that time credit markets will have stabilized, the federal stimulus and TARP programs will have begun to work, and financing for hospitals such as Marin General will be available.

While Shattuck Hammond's optimism is encouraging, other statements made in the meeting and in its written presentation suggest caution is in order. While the hospital has some characteristics of a good credit risk, such as a history of strong profitability, an affluent market, an experienced CEO and adequate size, the weaknesses that the firm identified are daunting. These include:

- "Limited balance sheet coupled with sizeable capital needs"
- "No recent history as a freestanding organization"
- "Relatively small, slow growth market"
- "Competitive threat posed by Sutter Health"

If the financing plan fails, one source told the Grand Jury, the district would look to the county and the district's IT consultant to provide part of the financing by accepting a delay in repayment of their loans and amortize them over several years. Under the current county loan agreement the county has the right to the first $20 million collected from accounts receivable after the transfer date. Under the transfer agreement, if less than $20 million is collected in the first 45 days after the transfer date, Sutter is required to make up the difference.

Finally, Shattuck Hammond alerted the board that any potential lender would have to be convinced that the hospital would continue to maintain the profitability that it has enjoyed under Sutter's management. The Grand Jury has serious reservations about the likelihood that Marin General will be able to do so as a stand-alone hospital.

Pressures on stand-alone hospitals

Proponents of a stand-alone hospital express a great deal of enthusiasm about Marin General's ability to operate profitably and compete effectively. The enthusiasts refer to the conclusions of the district's consultants as well as the success of district hospitals such as Washington Hospital in Fremont and El Camino Hospital in Mountain View. On its website, the Marin Healthcare District states that of "the 200 California hospitals which closed in the last ten years, only six have been district hospitals."

Supporters point to the history of profitability that Marin General has enjoyed over the years. In 2007 the hospital was profitable enough that Sutter was able to divert $38 million of excess revenues to other needs within its system. Over the 13-year period 1995-2007 a net total of $69 million was transferred from Marin General Hospital to other uses within the Sutter system. These monies, many say, could have been used to upgrade and enhance the hospital, and as a stand-alone entity such funds can be so used in the future. Bear in mind, however, that during this period Sutter made its capital resources available to Marin General to meet any financial challenges that might arise.

Notwithstanding this enthusiasm, there are compelling reasons for skepticism. Marin General's ability to operate as profitably as Sutter is problematic. KSA projects that the volume of patients will decline since competitors "will increase outpatient activities in Central Marin and attract patients away from [Marin General.]...The potential loss is equivalent to 20 percent of outpatient surgical/procedural cases and related ancillary services (i.e., lab, radiology)." Its revenues are likely to decrease further due to reduced reimbursements from Medicare, MediCal and third-party insurers. The Grand Jury has been told that Medicare reimbursements to hospitals are likely to decline 10 to 20 percent, due in part to curtailment of hospitals' practice of charging much higher rates for procedures that can be performed less expensively in outpatient settings. Approximately 48 percent of Marin General Hospital's more than $280 million in revenues comes from Medicare payments, which generally do not fully reimburse hospitals for their actual costs. Thus, such a reduction would mean a loss of $14 million to $28 million in revenues. KSA also warns that the population mix will change as each year "1 percent of the population will move into the 65+ age cohort...As the payor mix shifts from commercial payors to government payors, [Marin General] will need to be more competitive to maintain/attract commercial patients."

It is more difficult for a stand-alone hospital to negotiate favorable reimbursement rates from these commercial payers, comprised mainly of insurance companies. At one public board meeting, a doctor vividly described identical services that his children had received at Marin General and UCSF. Marin General was reimbursed by the insurance company at a much higher rate for the same service than was UCSF. He pointed out that unless an independent Marin General were able to obtain the same reimbursement rates as Sutter, the hospital's profitability would decline. Some Healthcare District officials assured the Grand Jury that the district would be able to obtain rates as favorable as Sutter since "insurance companies don't like dealing with Sutter because they are such tough negotiators." But the Grand Jury does not believe it plausible that insurance companies would give Marin General Hospital favorable reimbursement rates as a reward for separating from Sutter, particularly over the long term. It is more probable that the hospital's small size relative to the insurance companies would give it less leverage to negotiate high reimbursement rates. Indeed, one industry expert flatly stated, "It will have no bargaining strength... [and] will have to take the deal payers offer."

While its revenues are likely to decline, the expenses of the hospital likely will not. The district expects to borrow $50 million to repay existing indebtedness due at the transfer and for working capital. At 6 percent interest on $50 million, the interest payments alone

would amount to $3 million annually, more if the hospital is required to pay a higher rate. And the principal will need to be repaid as well. Additionally, the district is paying its CEO an annual salary and bonus that is more than $200,000 greater than is paid to the hospital's current CEO. The district plans to retain a bond advisor to assist in the campaign for a bond issue, to go along with the public relations consultant currently on retainer. In the district's most recent budget, these two items alone will amount to $700,000 in fiscal year 2010.

Moreover, the district is planning to continue using some of its other consultants on an ongoing basis. For example, the district has retained a consultant to negotiate insurance reimbursement contracts on its behalf at an estimated cost of $400,000 for the fiscal year beginning July 2009. These contracts, which larger health systems such as Sutter negotiate using in-house staff, are typically for a two-year period, and negotiations are time-consuming and often difficult. It is likely that this consulting expense will be ongoing. In addition, officials are not sure whether they will be able to obtain the kinds of quantity discounts available to the much larger Sutter system.

While there are successful stand-alone hospitals in California, they are rare. Some have advantages not available to Marin General, such as access to property tax revenues, the presence of a county hospital that absorbs much of the non-reimbursed care, and the absence of nearby competitors. Furthermore, a stand-alone hospital does not have the access to capital that a hospital in an affiliated system has. Unlike Marin General, a system such as Sutter can issue its bonds in the open market without taxpayer approval, and it has large cash reserves to act as a buffer in stormy times.

The economic crisis has also thrown a monkey wrench into the reliability of the past to predict future profitability. Industry publications point to the increase in charity care that is occurring in California. The Sacramento Business Journal reported in January 2009 that emergency room visits by the uninsured to California hospitals increased by 33 percent in recent months. Other publications reported capital budgets being slashed, lower utilization rates due to postponement of elective procedures, and pressure on margins due to underlying cost increases combined with inadequate reimbursement rates. One survey found that 55 percent of hospitals saw their patient volumes decline in the last half of 2008.

Marin General will be faced with similar difficulties, plus the added expense of millions of dollars in interest on working capital financing. With fewer profitable procedures, more unreimbursed charity care, and no significant ability to reduce costs to match reduced revenues, Marin General is not likely to maintain the robust profitability that the District Board is counting on.

Hospital governance is a lightning rod for dispute

Another obstacle to success is the conflict within the community over the advisability of the governance plan. One of the key recommendations made by KSA is the establishment of a "firewall" between the oversight role proposed for the five elected

members of the Healthcare District Board and the management role intended for the operating board, which is to be comprised of community leaders and industry experts more qualified to run a hospital than an elected board. The Grand Jury has been informed that, as a legal matter, as long as no Healthcare District Board member sits on the board of Marin General Hospital Corporation, it can continue to function as a private entity and will not be required to comply with the public meeting requirements of the Brown Act and numerous other laws that apply to publicly elected bodies. The Healthcare District Board has not adopted this recommendation and may not do so. But KSA and others have made it plain that the availability of financing, as well as the willingness of prominent members of the community and qualified experts to serve on the managing board of the hospital, is dependent upon the adoption of such a structure. In their view, the perception of instability due to political rancor makes it essential that the hospital be managed outside of the bright light of public meetings.

Some members of the community have voiced opposition to this proposed structure for operating the hospital. They point out that Marin General Hospital is a community-owned asset and as such the hospital's operations should be fully transparent. To appoint another board to perform this function may be an impermissible delegation of the board's fiduciary duty, according to some who oppose the "firewall" concept. One prominent critic has threatened a campaign to defeat a bond measure for seismic upgrades if such a governing system is put in place. Obtaining a two-thirds majority in support of a bond issue is difficult at best and may prove impossible if a vocal group opposes the firewall governing structure.

A sizable number of doctors, nurses, and hospital staff, as well as private citizens, has voiced support for Marin General to continue under Sutter's management. This group points to the excellent care patients receive at the hospital and the highly regarded cardiac, oncology, orthopedic, trauma and pediatric units Sutter has established. While Sutter is not perfect, they say, the hospital is well managed and responsive to the needs of patients and staff. They are particularly concerned with the ability of the district to raise the financing required for working capital and seismic improvements and have not been reassured by the statements from the board and its CEO. The Grand Jury has been told that some doctors and nurses have started making plans to relocate in case the district's plan is unsuccessful. Given California's acute shortage of nurses and technicians, this could be a serious problem. Because housing costs are so high, Marin has an additional problem of attracting doctors, nurses and technicians. Healthcare systems such as Sutter are better able to recruit and hire medical staff because of their innovative training programs and fully funded pension plans. Also of concern to some of the current staff is what they perceive to be the inherent instability of a board whose composition and direction can change with elections every two years.

Indeed, it is the opinion of many Grand Jury sources on all sides of the issues that the district itself, with its politically charged debates and acrimonious meetings, is a major impediment to a successful hospital. These sources believe that dissolution of the district would be an important step toward assuring the community and those doing business with it that Marin General is first and foremost concerned with providing patient care and

is not distracted from its mission by those advancing a political agenda. In this view, governmental regulation provides sufficient oversight to assure that hospitals provide quality care and the public involvement provided by the district system is unnecessary.

The Grand Jury interviewed an expert on the formation and dissolution of governmental agencies who stated that the process of dissolving the Healthcare District would begin with an application to the Local Area Formation Commission (LAFCO) made by the district, the Board of Supervisors or by a petition from 10 percent of the district's registered voters. LAFCO would consider the application and either approve it, deny it or approve it with conditions. The commission would primarily "be looking at what comes next," and evaluating who would be the successor to the district's assets and liabilities. If the application to dissolve were approved by LAFCO, it would go to district voters for final approval.

What now?

By going forward with its transition plan as outlined by KSA, the District Board is earnestly hoping that it can overcome all the potential financial difficulties outlined above, even though at least some board members do not have confidence in the plan's long-term success. Specifically, the hope is that:

- The economic recovery will be well underway in early 2010, and credit for hospitals will be available at reasonable rates.
- Commercial lenders will be willing to loan Marin General the sums needed for financial stability.
- The California Legislature will relieve hospitals (or at least Marin General) of the mandate to comply with seismic safety standards by 2013.
- The community is satisfied with the hospital governance structure established by the board, and the staff at Marin General remains at current levels.
- Accounts receivables will be paid on time so that 100 days of cash-on-hand is not needed.

If any of these conditions is not met, the likelihood of the hospital's long-term success is bleak. Even under the most favorable conditions, the probability is that Marin General will face declining revenues, increased costs and persistent capital shortages, which will impede its ability to compete with nearby hospitals and outpatient facilities.

The Grand Jury believes the risks of failure are unacceptably high and the best course for the community is to dissolve the district and transfer the hospital to a financially strong, highly regarded healthcare system. By agreeing to dissolve if acceptable terms can be agreed upon, the district would remove a critical impediment to attracting other healthcare systems to Marin General. Sutter may be the most logical healthcare system to approach with this proposal, although the Mayo Clinic and other well-regarded

systems previously approached on the district's behalf are also possibilities. While Sutter has been criticized by board members past and present, as well as some members of the community, it has a history with Marin General, is supported by its medical professionals, and has a regional presence. The Lewin Group, a highly respected healthcare consulting firm, recently named Sutter the top healthcare system based in California for quality and patient satisfaction.

The Grand Jury also believes that the time is overdue for the public to vote on the hospital's direction. The district electorate should decide whether the hospital should be professionally managed by a financially strong, well-regarded healthcare system or function as a stand-alone hospital. In this regard, the District Board should calculate and apprise voters of the estimated cost to taxpayers of the proposed bond issue to construct a new seismically safe hospital wing.

Accordingly, the Grand Jury recommends that the District Board contact highly regarded healthcare systems, including Sutter, to explore their interest in acquiring Marin General. Any agreement would be subject to the healthcare system's commitment to continue operating Marin General and comply with mandated seismic safety laws. It would also be contingent upon the affirmative vote of a majority of the district electorate to dissolve the district. Negotiations would initially work toward a memorandum of understanding, which would be presented to district voters for their approval. If approved, the parties would finalize the agreement, present it to LAFCO, and comply with whatever additional requirements LAFCO might impose.

The Grand Jury also recommends that the Marin County Board of Supervisors be a party to the exploratory process as well as the negotiations. The county has an enormous stake in the future of Marin General. Not only does it have a $20 million loan to the district, repayment of which may not occur on the agreed-upon timetable, but it also relies on the hospital to provide the safety net services required by state and federal law. The citizens of the county, as well, have a major stake in the hospital's continued availability for trauma care and other medical programs.

Because of the history of acrimony between the district and Sutter, the Grand Jury recommends that if the district chooses to negotiate with Sutter, a respected, experienced and mutually acceptable mediator assist the parties in their negotiations.

Depending upon the speed and efficiency with which the parties proceed, it may be necessary to seek an extension of the transfer date. Sutter offered in December 2008 to continue to operate the hospital under the lease until its expiration in 2015, and therefore might be amenable to an extension beyond June 29, 2010.

Above all, the Grand Jury recommends the board give district voters the opportunity to choose whether they want a stand-alone hospital or a hospital managed by a well-regarded healthcare system.

FINDINGS

The Grand Jury finds that:

F1. The Marin Healthcare District Board has a history of political turmoil and rancorous meetings. These problems have diminished somewhat, but disagreement remains among board members and some members of the public.

F2. Marin General provides high quality health care and has been commended by oversight agencies. It has many state-of-the-art programs and a highly regarded trauma unit.

F3. The Marin General emergency room treats more than 36,000 patients a year.

F4. Marin General provides important safety net services for the needy, including labor and delivery and psychiatric care.

F5. Under current law, Marin General must comply with mandated seismic safety laws by 2013. The Healthcare District has sought to qualify for extensions of the deadline but has been unsuccessful so far. There is a bill pending in the Assembly to extend the deadline for Marin General to 2015.

F6. The Healthcare District plans to comply with the seismic safety laws by constructing a new, seismically safe wing to the hospital at a cost of more than $300 million, financed by a bond issue to be paid by district taxpayers. The bond issue would require an affirmative vote of two-thirds of the district electorate.

F7. The Healthcare District and Sutter Health agreed to terminate the lease between the district and Marin General Hospital Corporation, which is controlled by Sutter Health. Sutter will return control of the hospital to the Healthcare District on June 29, 2010.

F8. The Healthcare District Board canvassed a number of well-known healthcare systems to determine their interest in taking over from Sutter Health and operating the hospital. No hospital system expressed interest in doing so. In addition to the capital commitments required, a key factor was a reluctance to deal with the politically charged nature of the Healthcare District.

F9. The Healthcare District hired Kurt Salmon Associates (KSA), a consulting firm, to advise it whether Marin General Hospital could succeed as a stand-alone hospital. KSA concluded that it could succeed, provided that, among other things, the hospital is governed by a board not subject to the political acrimony that has characterized the District Board meetings.

F10. The Healthcare District was unable to obtain transition financing from conventional sources and turned to the County of Marin for a $20 million loan, to be repaid within 45 days after the transfer date. The county agreed and has begun disbursements under the loan agreement.

F11. The healthcare industry deems days-of-cash-on-hand to be a critical factor in the strength of a hospital. In the third quarter of 2008, the median number of days-of-cash-on-hand for U.S. hospitals was 110.

F12. Marin General needs $800,000 to $1 million cash per day to pay its ongoing expenses. To comply with the industry standard, it should have between $80 million and $100 million in cash on hand.

F13. The Marin Healthcare District plans to operate the hospital with approximately $20 million in cash-on-hand. This money will come from $5 million that will be in the bank when Sutter transfers control to the district, and $15 million to be raised by the district's investment banker, Shattuck Hammond. The district is also considering using all or a portion of $5 million currently held by the Marin General Foundation to pay for architectural and design fees for the new wing.

F14. Financing of any kind is difficult to obtain at present for even the strongest businesses due to the worldwide financial crisis.

F15. The district's investment banker believes Marin General has significant weaknesses that could detract from its appeal as a credit risk, including a limited balance sheet; sizable capital needs; no recent history as a freestanding organization; a relatively small, slow growth market; and the competitive threat posed by Sutter Health.

F16. Over the 13-year period 1995-2007 a net total of $69 million was transferred from Marin General to the Sutter Health system.

F17. Approximately 48 percent of Marin General Hospital revenues come from Medicare reimbursements, which typically do not fully reimburse hospitals for their actual costs. KSA estimates that this percentage will increase by approximately 1 percent per year.

F18. It is difficult for stand-alone hospitals to negotiate reimbursement rates with private insurance companies that are as favorable as those negotiated by large healthcare systems.

F19. The expenses of Marin General Hospital are not likely to decrease after the Healthcare District resumes control, but its revenues are likely to do so.

F20. Hospitals, including Marin General, need very large amounts of cash to fund working capital; construction costs of up to $3 million per bed; and expensive equipment and technology.

F21. More than 40 percent of Marin residents are members of Kaiser Permanente health system and one-third of southern Marin residents use San Francisco hospitals rather than Marin General.

F22. Hospitals throughout California have had to absorb higher amounts of charity care, due in large part to the recession.

F23. Some vocal members of the community object to any hospital governance plan that would not subject the operating board to financial disclosure and public meetings.

F24. A sizable number of doctors, nurses and technical staff at Marin General Hospital prefer that the hospital remain under the direction of Sutter Health.

F25. Many people believe the district itself, with its political acrimony and frequent, bitterly contested elections, has become an impediment to optimizing the hospital's operation.

F26. The risks of failure of the district plan are unacceptably high.

F27. The voters of the district have never had an opportunity to vote whether the hospital should be managed by a financially strong, well-regarded healthcare system or should function as a stand-alone hospital.

F28. Dissolving the district would require the approval of the Local Agency Formation Commission (LAFCO) and the affirmative vote of a majority of the electorate in the district.

F29. Existing governmental regulation would provide sufficient oversight to assure that Marin General delivers quality care.

F30. If the district is unable to raise sufficient financing by the transfer date, it will look to the county and its information technology consultant to provide part of the financing by accepting a delay in repayment of their loans and amortize them over several years.

RECOMMENDATIONS

The Grand Jury recommends that:

R1. The Marin Healthcare District Board negotiate a memorandum of understanding with a highly regarded healthcare system, such as Sutter, to acquire Marin General. Any such agreement should be subject to the healthcare system's commitment to continue operating Marin General and comply with seismic safety laws. It should also be contingent upon the affirmative vote of a majority of the district electorate to dissolve the district.

R2. If district voters approve the memorandum of understanding, the district and the county take steps to finalize the agreement and the dissolution.

R3. The Marin County Board of Supervisors participate in the negotiation of the memorandum of understanding.

REQUEST FOR RESPONSES

Pursuant to Penal Code Section 933.05, the Grand Jury requests responses from the following governing bodies:

> Marin Healthcare District Board: All **Findings** and **Recommendations**.
>
> Marin County Board of Supervisors: **Findings 1, 2, 4, 5, 6, 7, 10, 21, 23, 25, 27, 28, 29** and **30** and **Recommendations 1, 2** and **3**.

The governing bodies indicated above should be aware that the comment or response of the governing body must be conducted in accordance with Penal Code Section 933 (c) and subject to the notice, agenda and open meeting requirements of the Ralph M. Brown Act.

California Penal Code Section 933 (c) states that "...the governing body of the public agency shall comment to the presiding judge on the findings and recommendations pertaining to matters under the control of the governing body." Further, the Ralph M. Brown Act requires that any action of a public entity governing board occur only at a noticed and agendized public meeting.

The Grand Jury invites responses from:

- Dr. Larry Bedard, Chair, Marin Healthcare District Board
- Dr. James Clever, Director, Marin Healthcare District Board
- Ms. Jennifer Reinks, Director, Marin Healthcare District Board
- Ms. Sharon Jackson, Director, Marin Healthcare District Board
- Dr. Hank Simmonds, Director, Marin Healthcare District Board

- Mr. Lee Domanico, Chief Executive Officer, Marin Healthcare District
- Chief of Staff, Marin General Hospital
- Chairman of the Board of Directors, Sutter Health
- Kaiser Permanente

Reports issued by the Civil Grand Jury do not identify individuals interviewed. Penal Code Section 929 requires that reports of the Grand Jury not contain the name of any person, or facts leading to the identity of any person who provides information to the Civil Grand Jury. The California State Legislature has stated that it intends the provisions of Penal Code Section 929 prohibiting disclosure of witness identities to encourage full candor in testimony in Civil Grand Jury investigations by protecting the privacy and confidentiality of those who participate in any Civil Grand Jury investigation.

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