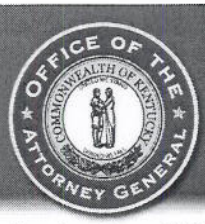


Proposed Consolidation of Jewish Hospital Healthcare Services, Inc., CHI Kentucky, Inc., Catholic Health Initiatives, University Medical Center, Inc., Jewish Hospital & St. Mary's Healthcare, Inc., Flaget Healthcare, Inc., Saint Joseph Health System, Inc., and JH Properties, Inc., to create a statewide network healthcare entity (the Kentucky Statewide Network) sponsored by Catholic Health Initiatives (70%), Jewish Hospital Healthcare Services, Inc. (14%) and the University of Louisville (16%)

Report of the Attorney General
29 December 2011

I. OBJECTIVE AND SCOPE OF THE REPORT

On June 14, 2011, Jewish Hospital Healthcare Services, Inc. (JHHS), CHI Kentucky, Inc., Catholic Health Initiatives (CHI), University Medical Center, Inc., Jewish Hospital & St. Mary's Healthcare, Inc. (JHSMH), Flaget Healthcare, Inc. and Saint Joseph Health System, Inc. (Amended and Restated Consolidation Agreement dated December 15, 2011 adding JH Properties, Inc. as a party) (Consolidation Parties), entered into a Consolidation Agreement envisioning the consolidation of their respective assets. (See Consolidation Agreement and Amended and Restated Consolidation Agreement attached as Exhibits A and B respectively)(The Consolidation Agreement and the Amended and Restated Consolidation Agreement are collectively referred to as the Consolidation Agreement). The resulting entity, the Kentucky Statewide Network (KSN), would provide hospital and healthcare services throughout most of Kentucky. KSN would be controlled by three sponsors in accordance with their respective sponsorship percentages: Catholic Health Initiatives (70%), Jewish Hospital Healthcare Services, Inc. (14%) and the University of Louisville (16%) (Sponsors).

Pursuant to the terms of the Consolidation Agreement, a proposed Sponsorship Agreement (attached as Exhibit C) and other related documents (Transaction Documents), KSN would control and operate all of the assets located in Kentucky being contributed by the Consolidation Parties, including the various hospitals and facilities owned or operated by them. Of particular note, pursuant to the Transaction Documents, KSN would control and operate University Medical Center, Inc. (UMC), and its assets. UMC's principal asset is the right to occupy and operate the University of Louisville Hospital (Hospital), a state owned asset, pursuant to the terms of the Amended and Restated Affiliation Agreement dated July 1, 2007 by and among the Commonwealth of Kentucky, the University of Louisville and UMC (Affiliation Agreement) (attached as Exhibit D) and a related Lease Agreement dated February 7, 1996 (Lease) (attached as Exhibit E).

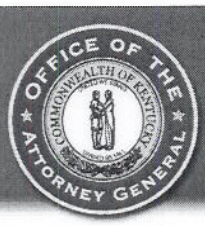
Pursuant to the Affiliation Agreement, neither UMC nor the University of Louisville may sell, transfer, or assign (including by operation of law) any interest in the University of Louisville Hospital without the consent of the Commonwealth of Kentucky, by and through the Governor and Secretary of the Finance and Administration Cabinet. The Transaction Documents envision and include a new affiliation agreement (New Academic Affiliation Agreement) and a new lease (New Lease) (see proposed form of documents attached as Exhibits F and G) by and among the Commonwealth of Kentucky, the University of Louisville, UMC and KSN, the terms of which are materially different from the present Affiliation Agreement and the Lease.

Because the proposed consolidation includes the New Lease and the New Academic Affiliation Agreement, requiring the agreement and consent of the Commonwealth of Kentucky, by and through the Governor and Secretary of the Finance and Administration Cabinet, and because of the significant and unprecedented public policy issues associated with the inclusion or use of state owned assets by an entity controlled by a private corporation, and subject to certain ethical and religious directives; as well as the principal mission of the University of Louisville Hospital as a public hospital and the principal provider of indigent healthcare to the Louisville region; the Governor of the Commonwealth of Kentucky Steven L. Beshear has requested Attorney General Jack Conway, with the assistance of Auditor of Public Accounts Crit Luallen, to review and report on the proposed consolidation.

(Capitalized Terms herein, not otherwise defined herein, shall have the meaning assigned to them in the relevant Transaction Documents).

II. UNIQUE CHARACTER OF THE TRANSACTION

Hospital systems across the country are consolidating to capture cost savings and streamline medical services. Hospitals subject to religious doctrine have in some cases merged with private secular hospitals in a few states, including New York and Washington. The proposed consolidation under review to operate the Hospital, a publicly owned teaching hospital that also serves as the public safety net hospital, and CHI, a Catholic hospital system subject to ethical and religious directives, is the first transaction of its kind in Kentucky, and there does not appear to have been another transaction involving all of the issues raised in the current proposed transaction anywhere else in the country. The current proposal presents a host of legal and public policy issues outlined below.



III. HISTORICAL OPERATION OF UNIVERSITY OF LOUISVILLE HOSPITAL

The University of Louisville Hospital traces it origin to the 1817 establishment of the Louisville Hospital Company.[1] It was known as Louisville Marine Hospital until 1849; thereafter, it was known as Louisville City Hospital until 1942 when the name was changed to Louisville General Hospital.[2] By agreement with the City of Louisville, in 1927, the University of Louisville assumed responsibility for medical services at the Louisville General Hospital.[3] By 1939, the hospital had become officially affiliated with the University of Louisville and in 1979, the Hospital was deeded to the Commonwealth of Kentucky for the use and benefit of the University of Louisville. In the Commonwealth, by statute, property used by universities and other state agencies is titled in the name of the Commonwealth of Kentucky, and is designated for the use and benefit of the particular university or agency. This designation reflects the ongoing role of the Commonwealth in all property management aspects of universities and agencies. In the present case, the relevant property is a state asset operated as a teaching hospital by the University of Louisville for the benefit of the citizens of the Commonwealth, and subject to laws and regulations applicable to state assets.

Beginning in January of 1983, Humana Health Care operated the Hospital[4] on behalf of the University of Louisville, pursuant to an affiliation agreement signed by Humana of Virginia, Inc. and the University of Louisville. On February 6, 1996 the affiliation agreement, and related lease, with Humana Health Care, then known as Columbia/HCA, was terminated by the parties.

Due to the termination of the contract with Columbia/HCA, a Request for Proposals (1995 RFP) to operate the Hospital was issued in 1995 by the University of Louisville. Alliant Health System, Inc. (now Norton Healthcare, Inc.)(Norton), Jewish Hospital Healthcare Services, Inc. (subsequently Jewish Hospital & St. Mary's HealthCare, Inc.)(Jewish Hospital), and the University of Louisville formed UMC as a Kentucky nonprofit corporation for the purpose of responding to the 1995 RFP. There were four proposals submitted to operate the Hospital on behalf of the University of Louisville.[5] UMC's proposal was selected, and in 1996, the Commonwealth of Kentucky, the University of Louisville and UMC entered into the Affiliation Agreement and the Lease.

UMC is a Kentucky nonprofit corporation incorporated in 1995. Prior to July 1, 2007, UMC was controlled by Norton, Jewish Hospital and the University of Louisville. On July 1, 2007, Norton and Jewish Hospital withdrew from membership, and the University of Louisville assumed complete control of UMC.[6] This removal of the private members of UMC, with the only remaining controlling entity being the University of Louisville, was memorialized in the Affiliation Agreement by and between the Commonwealth of Kentucky, acting through the Governor and the Secretary of the Finance and Administration Cabinet, the University of Louisville, acting through its Board of Trustees, and UMC.

Since 2007, UMC, now solely controlled by the University of Louisville, has continued to operate the Hospital, and, pursuant to the Affiliation Agreement, has made significant financial payments to the University of Louisville in the nature of lease payments, fees for services and surplus cash flow to support the University's medical school health science programs. In exchange for the proposed continued use of state assets, i.e. the Hospital, similar payments are proposed to continue and increase, as well as additional financial benefits to the University of Louisville, if the proposed transaction is completed.

Current and Proposed Financial Benefits to the University of Louisville

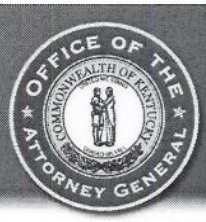
Current

- UMC pays $11.0 million annually to UofL
- UMC pays $500,000/month in lease payments to UofL
- UMC makes fee-for-service payments to UofL

Proposed

- UMC pays UofL $11.0 million annually with CPI-based adjustments
- UMC pays $6 million/annually in lease payments to UofL
- UMC makes fee-for-service payments to UofL

1 http://www.uoflhealthcare.org/Default.aspx?tabid=358 (July 31, 2011); http://special.library.louisville.edu/display-collection.asp?ID=627 (December 19, 2011).
2 http://www.uoflhealthcare.org/Default.aspx?tabid=359 (July 31, 2011)
3 http://www.university-hospital.org/about-the-hospital/who-we-are/history/ (November 4, 2011).
4 http://www.university-hospital.org/about-the-hospital/who-we-are/history/ (November 4, 2011)
5 1995 WLNR 5076760
6 See 11-ORD-157



- UofL participates in distributions of KSN surplus net revenues, receiving 10% of initial surplus net revenues with 16% of the remaining surplus net revenues to be distributed.[7]

IV. NATURE OF UMC

The Attorney General determined, in 11-ORD-157 (attached as Exhibit H), that UMC is a public agency pursuant to KRS 61.870(1)(j) because it is an "agency which is 'established, created, and controlled' by a public agency as defined in the statute." See *University of Louisville Foundation, Inc. v. Cape Publications, Inc.*, 2003 WL 22748265 at p. 5 (Ky. App.). See also, *Cape Publications, Inc. v. University of Louisville*, 260 S.W.3d 818 at 822-823 (Ky. 2008).

UMC was established and created in June 1995 "to operate and maintain the hospital affiliated with the University of Louisville School of Medicine, and to provide medical care for the people who are in need of those, or related, medical services."[8] In October 1995, following the 1995 RFP, the University awarded the management contract for University Hospital to UMC. The "causal connection" between the formation of UMC in June 1995 and the execution of the Affiliation Agreement among UMC, the University and the Commonwealth in October 1995 is as clear and direct as the causal relationship between the University of Louisville Foundation and the University of Louisville recognized in *University of Louisville Foundation, Inc. v. Cape Publications, Inc.*, above." The University has, in its own words, "partnered" with UMC since its inception.[9]

Presently, control of the Hospital remains in the University's hands by virtue of its strong presence on UMC's Board of Directors and the powers reserved to it under the Affiliation Agreement. In 2007, when Norton and Jewish withdrew from UMC, the University credited the University president with achieving the goal of "sole U of L management" of "[t]he Board of Directors of University Hospital."[10]

UMC's Board of Directors consists of seventeen voting members and is chaired by the president of the University or his designee.[11] Unlike the other Board members, the chair of UMC's Board may not be removed by a majority vote.[12] Section 4.02(a) of UMC's bylaws authorizes the chair to appoint four to seven additional University directors who must include the Dean of the University's Medical School, the University's Executive Vice President for Health Affairs, the chair of one of the Medical School's clinical departments, and a member of the University's Board of Trustees. Although the remaining Board members are "community" members, nominated by the Board's nominating committee and voted on by the Board, the nominating committee is chaired by the president of the University or his designee and consists of an additional University member and two community members who are appointed by the chair.[13] The University therefore exercises broad control over all appointments to the Board through its president, or his designee. Not only is he authorized to appoint up to half of UMC's Board members, he significantly influences, if not controls, appointment of the remaining members through his role as chair of the nominating committee. Additionally, he cannot be removed.

Under the terms of the Affiliation Agreement, UMC agrees:

- that University Hospital will "serve as the principal adult teaching hospital of [the] University and shall be available for teaching, research, and clinical care programs of the University Schools of Medicine, Dentistry, Nursing and Public Health plus residency programs and other programs mandated by state law";[14]
- that it will obtain University approval before implementing new programs[15] or withdrawing any training pro-

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7 The proposed Sponsorship Agreement (see Exhibit C) sets forth the Sponsors' rights to receive contingent future mandatory KSN payments. Under Section 2.2(B)(2) of the Sponsorship Agreement, KSN compares its operating margin with the Median Operating Margin for not-for-profit freestanding hospitals with a credit rating of A1 as published by Moody's Investor Services, Inc. If KSN's operating margin exceeds the Median Operating Margin, then KSN makes payments to the Sponsors to further their charitable missions. The amount of the total payment is the amount of cash in excess of reasonable reserves established by the KSN board, including capital expenditure reserves, that does not cause KSN to fall below the Median Cash on Hand and Median Cash to Debt for not-for-profit freestanding hospitals with a credit rating of A1 after giving effect to such payments.

For the University of Louisville, under Section 2.2(B)(2)(a), the first 10% of the total payment is transferred to the University of Louisville for use in its health sciences schools and related life science activities. This distribution amount is not subject to change even if there is a change in the University's Membership Interest Percentage. Under Section 2.2(B)(2)(b), the University of Louisville thereafter participates by receiving a share of the remaining payment in accordance with its Membership Interest Percentage (16% upon the execution of the transaction). Payments to the University under the latter sub-part are not restricted to use in health sciences schools and related life science activities. The restriction is that the payments must be applied to further the charitable mission of the University of Louisville.

8 Articles of Incorporation of University Medical Center, Inc., Article 2A.[1].

9 University Hospital: History. http://www.woflhealthcareorg/AboutUs/History/tabid/358/Default.aspx

10 Minutes of the Regular Meeting of the Board of Trustees of the University of Louisville, July 12, 2007. http://louisville.edu/president/trustees/minutes/2007/minutes%207%2012%2007.pdf

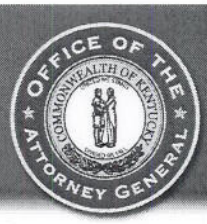
11 UMC Bylaws (as amended January 2008), at 4.01 and 4.02(a).

12 UMC Bylaws 4.04.

13 Bylaws 6.01(B); 6.03.

14 Affiliation Agreement 5.1.1.

15 Affiliation Agreement 7.1.



gram;[16]

- that the Dean of the University's School of Medicine, or his designee, will serve as Chief of the Hospital's medical staff ;[17] and
- that it will obtain prior University approval for "all agreements between any member or members of the faculty and UMC or any Affiliate or party acting on UMC's behalf including network participation agreements, clinical practice agreements, or insurance, provider, or capitation products".[18]

The Affiliation Agreement also requires UMC to manage University Hospital without charging the University a management fee and to remit all "surplus cash flow arising throughout the term of this Agreement" to the University.[19] The contractually mandated financial distributions between the two entities further underscore the significant organizational interconnectivity.

This financial arrangement is important because of UMC's status as a non-profit, tax exempt 501(c)(3) organization. UMC cannot, without violating its fiduciary duty to confer benefits in conformity with its purpose, make a distribution to the University of Louisville unless the University is part of UMC.[20] Just as the University of Louisville Foundation could not receive "Bucks for Brains" money and contributions unless it was acting "as one and the same" with the University, so UMC cannot distribute surplus cash flow to the University unless it acts "as one and the same" with the University.

In the proposed consolidation, the University stands to gain a minimum investment in the Teaching Hospital of $200 million from KSN, in addition to $11.0 million annually with CPI-based adjustments, $542,000 per month in lease payments, fee-for-service payments, and participation in distributions of KSN surplus net revenues of 10% of all surplus net revenues and 16% of all remaining surplus net revenues to be distributed.

Throughout, the University has been a, if not the, chief proponent of the consolidation. Yet, over the course of the last six months, University representatives have repeatedly asserted that the University is not a "party" to the consolidation, just UMC is. This repeated assertion is a distinction without a difference because: (i) the University is a principal beneficiary, financially and otherwise, of the proposed consolidation, (ii) the University is a formal party to the Sponsorship Agreement, (iii) the University shares legal counsel with UMC in the transaction, and (iv) the University presently controls UMC. The fact of the matter is that the University of Louisville is a party to the consolidation by virtue of being a party to the Sponsorship Agreement and by and through its alter ego, UMC.

V. THRESHOLD LEGAL ISSUES

A. Acquisition and Disposition of State Assets.

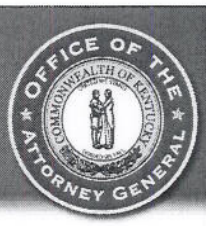
KRS Chapter 45A, relating to state owned assets, and KRS Chapter 164A, relating to higher education finance, provide a framework for the acquisition and disposition of state assets. The Finance and Administration Cabinet generally is the agency responsible for acquiring or disposing of state assets through a public process. However, pursuant to KRS 164A.550, state public universities may assume this role through enactment of a regulation. The University of Louisville elected, through its Board of Trustees, to manage purchasing, inventories, sale of surplus property, and bidding procedures through the enactment of 740 KAR 1:030. The regulation specifically provides that the University of Louisville will manage its interests in real property and contractual services in accordance with policies and procedures approved by the Board of Trustees, and subject to applicable portions of KRS Chapter 45A.

Consistent with its authority under KRS Chapter 164A and 740 KAR 1:030, the University of Louisville issued the 1995 RFP for operating the Hospital as described above. UMC was selected as the operator and the Commonwealth of Kentucky, the University of Louisville and UMC entered into the Affiliation Agreement and the Lease.

As part of the proposed consolidation, the Consolidation Parties and the Sponsors are requesting the Commonwealth of Kentucky to enter into the New Academic Affiliation Agreement and the New Lease. The terms of the proposed New Academic Affiliation Agreement and the New Lease present material differences from the current Affiliation Agreement and Lease, likely triggering the requirements of KRS Chapter 45A and KRS Chapter 164A as those statutes relate to the disposition of state assets by the University of Louisville, in this case the Hospital and the right to operate it.

First, the New Academic Affiliation Agreement and Lease significantly extend the term of years during which UMC operates and occupies the

16 Affiliation Agreement 5.2
17 Affiliation Agreement 8.2
18 Affiliation Agreement 22
19 Affiliation Agreement 11.2 and 11.4
20 KRS 273.237 provides in pertinent part, "… A corporation may pay compensation in a reasonable amount to its members, directors, or officers for services rendered, may confer benefits upon its members in conformity with its purposes.…"



Hospital. The present Affiliation Agreement and Lease have a term effectively ending on or about February 6, 2026. The New Academic Affiliation Agreement and the New Lease would extend the term by fifty-five years, effectively ending during calendar year 2081.

Second, while UMC will remain as a corporate entity within KSN, there will be a material change in control of UMC. As noted above, UMC presently is effectively and solely controlled by the University of Louisville.[21] Under the proposed transaction, UMC would be totally controlled by KSN. KSN in turn will be controlled by the Sponsors in accordance with their respective sponsorship percentages and pursuant to the proposed sponsorship agreement among the Sponsors (Sponsorship Agreement) (Sponsorship Agreement attached as Exhibit C). As a result, the University of Louisville will only have indirect and minority influence over the affairs of UMC and its use of state assets.

As a result of the foregoing material changes, and potentially as a result of additional material changes to the terms of the Affiliation Agreement and Lease, the University of Louisville must comply with state laws relating to the disposition of state property, codified in KRS Chapter 45A and KRS Chapter 164A, and its own policies and procedures adopted by the Board of Trustees, as they relate to the leasing or other disposition of state assets to private parties. KRS 164A.575(1) (attached as Exhibit I) contains exceptions to the competitive bidding process for contractual services where no competition exists and when services are available from only one source. KRS 164A.575(7) allows the governing board to sell or dispose of real property of the institution through an established process, requiring an express resolution of the board. Based on a review of the Transaction Documents and Board of Trustee minutes, and particularly the minutes from November 10, 2010[22] and June 9, 2011[23], it does not appear that the University of Louisville has yet complied with these applicable statutory provisions.

The foregoing relates to a disposition of state assets. Additionally, in the event of an unwind of the proposed consolidation, the University of Louisville would be forced to purchase assets in addition to retaking possession of the Hospital. If an unwind were to occur, this requirement would amount to a forced acquisition of new assets by the University of Louisville, without the procurement process required by KRS 164A, applicable portions of KRS 45A, and the policies and procedures of the University of Louisville[24] required by 740 KAR 1:030 (attached as Exhibit J).

Specifically, if there is a termination of the New Academic Affiliation Agreement for any reason, then KSN shall sell, assign, and otherwise transfer, and the University of Louisville shall purchase and acquire all of KSN's right, title, and interest in and to the "Teaching Hospital Business" (as defined under the Sponsorship Agreement, i.e. the downtown facilities utilized as the University of Louisville's teaching hospital, including the downtown Jewish Hospital, Frazier Rehab, and any facilities added as a result of the consolidation).

In addition, if there is a termination of the New Academic Affiliation Agreement for any reason set out therein, KSN would also have the right to force the University of Louisville to purchase all of KSN's right, title, and interest in and to some or all of the business and facilities operated by KSN in Jefferson County. In basic terms, this provides KSN the right to force the University of Louisville to purchase the JHHS/JHSMH Jefferson County contribution to KSN, and any additional facilities. Therefore, there is the possibility that the University of Louisville will have to acquire significantly more assets, as well as assume significantly more liabilities, in an unwind in order to regain control over the Hospital in its current form.

The above described potential acquisitions by the University of Louisville would require compliance by the University with the applicable provisions of KRS Chapters 45A and 164A, as well as and the policies and procedures of the University of Louisville required by 740 KAR 1:030.

B. A Potential Unwind of the Consolidation

In addition to the public disposition and procurement issues arising out of a potential unwind of the consolidation transaction, such unwind would have significant financial and operational implications. The proposed Sponsorship Agreement addresses events which could trigger an unwind of the consolidation.

1. CHI Change in Control

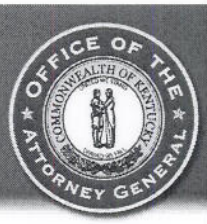
Section 7.1(B) of the Sponsorship Agreement addresses a CHI Change in Control. Under Section 7.1(B), a CHI Change of Control is a merger, sale, or disposition of all or substantially all the assets, or other transaction involving CHI that results in a new entity other than the CHI Board of Stewardship Trustees or Public Juridical Person, having the right to appoint a majority of the directors of CHI or the successor entity to CHI resulting from the Change of Control Transaction. If there is such an event, CHI will provide notice to the University requesting consent to the change in control transaction. Per the Sponsorship Agreement, the University's consent may not be unreasonably withheld. If the University

21 The Attorney General held in 11-ORD-157 (attached as Exhibit H) that UMC is a public agency for the purposes of the Open Records Act, due to University of Louisville control of UMC. The University of Louisville has appealed this decision to the Jefferson Circuit Court in University Medical Center In. vs. American Civil Liberties Union of Kentucky, Inc., et al, Case No. 11-CI-007219.

22 http://louisville.edu/president/trustees/minutes/2010/BOTmin11-11-10.pdf

23 http://louisville.edu/president/trustees/minutes/2011/BOT%20minutes%206-8-11.pdf

24 http://louisville.edu/purchasing/policies



does not consent, then for one year following the effective date of the change in control event, the University will use best efforts to negotiate in good faith with the new entity that controls CHI to determine if the University wants to continue as a Sponsor. If after one year the University does not want to continue as a Sponsor, then it must provide CHI, JHHS, and KSN with notice. Such Notice is an "Affiliation Termination Event" that terminates the New Academic Affiliation Agreement, and triggers an unwind of the University's interest in KSN.

2. Withdrawal of a Sponsor

Section 7.2 of the Sponsorship Agreement addresses a potential withdrawal of a Sponsor. Under Section 7.2(A)(1) of the Sponsorship Agreement, if the Sponsors receive an opinion from a qualified outside counsel retained by the withdrawing Sponsor that the continuation of that Sponsor's membership interest in KSN would result in the loss of the withdrawing Sponsor's federal tax-exempt status or the federal tax-exempt status of any bonds issued on its behalf and the cause of such loss cannot be cured and all appeals to the appropriate governmental authorities have been exhausted, then that Sponsor's withdrawal is permitted.

In addition to the potential withdrawal of any Sponsor as set forth above, under Section 7.2(A)(2) of the Sponsorship Agreement, JHHS is permitted to withdraw in the event of a change in the activities of KSN which would, in the reasonable opinion of JHHS, cause the Jewish Facilities (as defined in the Sponsorship Agreement) to not be in compliance with the Jewish Heritage and the cause of such non-compliance cannot be cured.

Both of the foregoing withdrawal events are subject to a dispute resolution process under the Sponsorship Agreement. Any withdrawal may have significant effect on the continuity of the consolidation. A withdrawal of JHHS under Section 7.2(A)(1) or (2) does not terminate the New Academic Affiliation Agreement, and would not trigger an unwind of the University's interest in KSN. A withdrawal of CHI or the University under Section 7.2(A)(1) is an unwind event; however, such a withdrawal is not defined as an "Affiliation Termination Event" under Section 8.1(A) of the Sponsorship Agreement, which would terminate the New Academic Affiliation Agreement.

In the event of a withdrawal of a Sponsor, Section 7.2(C)(1) of the Sponsorship Agreement, entitles the withdrawing Sponsor to receive from KSN consideration for the Sponsor's membership interest in an amount equal to 100% of the fair value of the membership interest as of the effective date of the withdrawal. Notably, this section does not expressly provide for the transfer of the Teaching Hospital to the University; therefore, there is a scenario in which the University could withdraw as a Sponsor while the Teaching Hospital remains with KSN.

To potentially protect against a scenario in which the University could withdraw as a Sponsor without ensuring the transfer of the Hospital back to the Commonwealth and the University, Section 19.2(c)(vi) of the New Academic Affiliation Agreement provides if the New Lease is terminated without the University's consent, then the New Academic Affiliation Agreement is terminated, and Section 8.1 of Sponsorship Agreement would be triggered requiring a transfer of the Hospital back to the University and the Commonwealth. Thus, the Commonwealth could force an unwind which would include a transfer of the Hospital to the University and the Commonwealth by terminating the New Lease in the event of a withdrawal of the University under Section 7.2 of the Sponsorship Agreement. However, in the event that the University consents to the termination of the New Lease, it is not clear that the New Academic Affiliation Agreement would expressly terminate, and it is not clear that the withdrawal under Section 7.2 of the Sponsorship Agreement would necessarily, by its terms, result in a transfer of the Hospital back to the University and Commonwealth. Hence, there appears a possibility of a scenario in which the University could withdraw as a Sponsor but the Hospital would stay with KSN.

3. Removal of a Sponsor

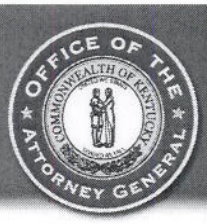
In addition to the potential withdrawal of a Sponsor, it is also possible for a Sponsor to be removed. Section 7.2(B) of the Sponsorship Agreement sets out the removal events. Removal occurs if there is a "Removal Event" (described below) and the Sponsors are unable to reach an alternate course of action through the dispute resolution process. In such an event, the non-breaching Sponsors have the right to provide notice to the breaching Sponsor of removal as a Sponsor of KSN.

<u>a. Expulsion or Suspension from Government Program</u>

Under Section 7.2(B)(1) of the Sponsorship Agreement, if the non-breaching Sponsors receive an opinion from qualified outside counsel that the continued membership of the breaching Sponsor would result in the expulsion or suspension of KSN from participation in any government program, e.g. Medicaid, and the cause cannot be cured, or the breaching Sponsor fails to commence the cure within thirty (30) days of notice, and all appeals to the appropriate governmental authorities have been exhausted, then the breaching Sponsor may be removed.

<u>b. Jeopardy to Tax-Exempt Status</u>

Under Section 7.2(B)(2) of the Sponsorship Agreement, if the non-breaching Sponsors receive an opinion from qualified outside counsel that the



continued membership of the a Sponsor would result in the loss of KSN's federal tax-exempt status or the federal tax-exempt status of any bonds issued on behalf of the KSN, and the cause of the loss cannot be cured, or can be cured by the offending Sponsor but the offending Sponsor fails to commence the cure within thirty (30) days of notice, and all appeals to the appropriate Governmental Authorities have been exhausted, then the offending Sponsor may be removed.

c. Performance of Prohibited Procedures

Under Section 7.2(B)(3), if CHI reasonably determines that KSN or any of its facilities has provided or continues to provide procedures that are described as restricted or prohibited in the Sponsorship Agreement (identified on Exhibit G thereto) due to the willful and intentional actions of the offending Sponsor or any of its related entities, then the offending Sponsor may be removed.

On a related note, Under Section 7.3 of the Sponsorship Agreement, if CHI reasonably determines that it needs to amend Exhibit G of the Sponsorship Agreement so that CHI does not fall out of compliance with the ERDs, and the other parties do not agree after going through the dispute resolution process, then CHI has the option to provide JHHS and the University with a CHI Election Notice of an Affiliation Termination Event pursuant to Section 8.1(A). Such an election is deemed a non-renewal of the New Academic Affiliation Agreement and it triggers a transfer of the Hospital.

d. Additional Removal Events

Additionally, under Section 7.2(B)(4) of the Sponsorship Agreement, the bankruptcy, liquidation, or dissolution of a Sponsor or, under Section 7.2(B)(5), an uncured material breach by a Sponsor, are Removal Events under the Sponsorship Agreement.

e. Effect of Removal

As with the occurrence of a withdrawal, under Section 7.2(C)(1) of the Sponsorship Agreement, the effect of a removal of a Sponsor is that the effected Sponsor shall be entitled to receive from KSN consideration in an amount equal to 100% of the fair value of the effected Sponsor's Membership Interest as of the effective date of the removal. If the University is removed from KSN without its consent, the event terminates the New Lease. Also, as with the occurrence of a withdrawal, there are possible scenarios under which the University, if it is removed as a Sponsor, the transfer of the Hospital to the University and the Commonwealth possibly would not take place under Section 7.2 of the Sponsorship Agreement (see discussion in subsection 2 "Withdrawal of Sponsor" above).

4. Agreement of Sponsors to Terminate

Under Section 9.1 of the Sponsorship Agreement termination will occur upon the mutual written agreement of all of the Sponsors or when there is only one Sponsor. A termination of the Sponsorship Agreement under Section 9.1 does not address the transfer of the Hospital or the Jefferson County Business. Instead, under Section 9.2, if the Sponsorship Agreement is terminated in this manner, the Sponsors will mutually agree upon the effect of such termination and the dissolution and liquidation or other disposition of KSN and its assets and liabilities.

5. Termination of New Academic Affiliation Agreement

a. Expiration of Term

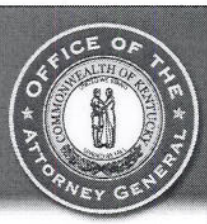
The New Academic Affiliation Agreement terminates at the end of the "Term" which means the "Initial Term" (twenty-five years) and any and all "Renewals Terms" (three renewal periods of fifteen years each).

b. Material Breaches

KSN may, under Section 19.2(b) of the New Academic Affiliation Agreement, terminate by providing a written termination notice to the University upon the occurrence of a material breach of certain sections of the New Academic Affiliation Agreement, but only after the expiration of the "Negotiation Period" described in Section 20.1 of the New Academic Affiliation Agreement.

The University may, under Section 19.2(c) of the New Academic Affiliation Agreement, terminate by providing a termination notice upon the occurrence of a monetary breach relating to a failure to pay an undisputed (in good faith) and agreed upon sum of money when due.

Under Section 19.2(c), the University may also terminate for a breach of any of the following events (but only after the expiration of the "Negotiation Period"):



(i) The University has an option, under Section 19.2(c)(i), to terminate if KSN's financial position renders it insolvent or KSN makes a general assignment for the benefit of creditors. Additionally, under Section 19.2(c)(i), the University may terminate if a petition in bankruptcy is filed by KSN, or such a petition is filed against and consented to by KSN or not dismissed within thirty (30) days. Finally, under this sub-part, the University may terminate if a bill in equity or other proceeding for an appointment of a receiver of KSN or other custodian for KSN's business or assets is filed and consented to by KSN, or if a receiver or other custodian of KSN's assets or property, or any part thereof, is appointed.

(ii) Under Section 19.2(C)(ii), the University may terminate upon the occurrence of a material breach of certain sections of the New Academic Affiliation Agreement including the failure of KSN to make any payments required under any approved "NTH (New Teaching Hospital) Investment Plan." However, the (a) failure of the NTH Committee (as defined in section 10 the Academic Affiliation Agreement) to present the NTH Investment Plan to the KSN Board, (b) the failure of the KSN Board to approve the NTH Investment Plan, and/or (c) the submission of a dispute regarding the NTH Investment Plan, do not constitute a breach of the New Academic Affiliation Agreement. Effectively, only a failure in payment is a breach.

(iii) Under Section 19.2(C)(iii), if KSN willfully, intentionally, and repeatedly breaches a material provision of the New Academic Affiliation Agreement after it has received written notice from the University with respect to the breach, the University may terminate the New Academic Affiliation Agreement.

(iv) Under Section 19.2(C)(iv), the University may terminate if KSN fails to comply in all material respects with any arbitration award granted under Section 20.2 of the New Academic Affiliation Agreement.

(v) Under Section 19.2(C)(v), the New Academic Affiliation Agreement terminates upon the closing of the purchase of the Hospital by the University pursuant to Section 8 of the Sponsorship Agreement.

(vi) Under Section 19.2(C)(vi), if the New Lease is terminated without the University's consent.

(vii) A default by UMC under the New Academic Affiliation Agreement is an event of default under Section 18(A)(e) of the New Lease.

6. Commonwealth's Termination Rights

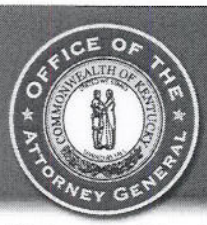
By letter dated November 10, 2011 from the Sponsors and UMC to the Commonwealth (attached as Exhibit K),[25] the Sponsors and UMC agree, in consideration of the Commonwealth's entering into the New Academic Affiliation Agreement and the New Lease, in the event of (a) a breach of the Transaction Documents; (b) the expiration of any applicable cure periods; (c) the failure of any applicable dispute resolution procedures called for in the Transaction Documents to resolve such breach to the satisfaction of the University; and (d) the University's failure or refusal to exercise its rights, the Commonwealth will have the right, independent of the right of the University, to exercise any and all rights of the University to terminate or enforce the Transaction Documents in accordance with their respective terms.

While the foregoing grant of direct rights to the Commonwealth is significant, it should be noted that the Commonwealth may only exercise such rights if all conditions are satisfied, notably including the University's refusal to exercise the same rights. As such, the letter does not grant the Commonwealth independent rights to terminate any portion of the proposed consolidation.

C. Effect of Termination of New Academic Affiliation Agreement or a CHI Change in Control - Transfer of Teaching Hospital Pursuant to Sponsorship Agreement

The Sponsorship Agreement sets forth the agreement among the Sponsors in the event there is a required transfer of the Teaching Hospital to the University and the Commonwealth. If (i) the New Academic Affiliation Agreement is terminated or is not renewed at the end of its "Term" or any "Renewal Term," (ii) if the University delivers notice to CHI and JHHS following a CHI Change of Control, or (iii) if CHI delivers notice to JHHS and the University in connection with an unresolved dispute concerning a lack of agreement regarding an amendment to Exhibit G (the list of restricted or prohibited services), then KSN shall sell, assign and otherwise transfer, and the University shall purchase and acquire all of KSN's right, title and interest in and to the "Teaching Hospital Business." The three foregoing occurrences are the only expressly identified events which require a transfer of the Teaching Hospital Business to the University. (See above discussions titled "Withdrawal of a Sponsor" and "Removal of a Sponsor").

25 The letter remains unsigned as of the date hereof and would need to be fully executed prior to the approval or consummation of the proposed consolidation.



1. Purchase Price for Teaching Hospital Business (University of Louisville Hospital, the James Graham Brown Cancer Center, Jewish Hospital and Frazier Rehab Institute)

Section 8.1(D) of the Sponsorship Agreement identifies the formula for the Purchase Price for The Teaching Hospital Business. The purchase price for the Teaching Hospital Business is the sum of the Fair Value of the Teaching Hospital Business as of the Termination Closing Date less the amount of the Teaching Hospital Business Assumed Liabilities as of the Termination Closing Date, and less the Fair Value of the University's Membership Interest as of the Termination Closing Date. The Fair Value of each variable of the formula is determined by an appraiser mutually acceptable to the parties.

Because the Teaching Hospital Facilities under the Sponsorship Agreement are defined as the University of Louisville Hospital and the James Graham Brown Cancer Center as well as Jewish Hospital and Frazier Rehab Institute, the Teaching Hospital Business is by definition an interest greater than the "Old ULH" as that term is defined in the New Academic Affiliation Agreement. The significance of the difference is that Old ULH represents the UMC contribution to KSN. The University will be required to purchase and acquire assets in addition to those contributed by UMC. Therefore, if there is an unwind, it is likely that the application of a credit toward the Purchase Price of the Fair Value of the University's Membership Interest in KSN will not be sufficient to acquire the Teaching Hospital Business (and Assumed Liabilities).

2. Purchase Price for Teaching Hospital Business Plus Jefferson County Business (University of Louisville Hospital, the James Graham Brown Cancer Center, Jewish Hospital and Frazier Rehab Institute Plus Assets Contributed by JHHS/JHSMH, and Any Additional KSN Facilities in Jefferson County at Time of Unwind)

Under Section 8.1(B) of the Sponsorship Agreement, KSN has a "Put Right" to cause the University to purchase all of KSN's right, title and interest in and to some or all of the business and facilities operated by KSN in Jefferson County (the Jefferson County Business). Within 120 days after an Affiliation Termination Event, KSN may exercise the Put Right. If KSN exercises this right, then the University must purchase more than the Teaching Hospital Facilities. The formula for the Purchase Price is the Sum of the Fair Value of the Teaching Hospital Business and the Jefferson County Business as of the Termination Closing Date less the amount of Teaching Hospital Business Assumed Liabilities and Jefferson County Business Assumed Liabilities as the Termination Closing Date less the Fair Value of the University's Membership Interest as of the Termination Closing Date. As with a scenario in which KSN does not exercise its Put Right, the Fair Value of each variable of the formula is determined by an appraiser mutually acceptable to the parties. If there is an exercise of KSN's Put Right, the University will be required to purchase and acquire all of the Jefferson County assets contributed by JHHS/JHSMH. The credit for the University's Membership Interest in KSN will not be sufficient to satisfy the Purchase Price.

D. Termination of Contracts Pursuant to 200 KAR 5:312

Section 3 of KAR 200 KAR 5:312 (attached as Exhibit L) permits the Commonwealth of Kentucky to terminate a contract for the convenience of the Commonwealth "if the purchasing officer has determined that the termination will be in the Commonwealth's best interest." The Commonwealth provides the contractor with a thirty (30) calendar day written notice of the termination unless the Secretary of the Finance and Administration Cabinet or his designee makes a written determination that a shorter notice of termination for convenience is in the best interest of the Commonwealth.

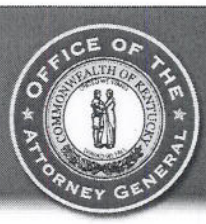
The Commonwealth of Kentucky is being asked to enter into the New Lease for the use of the Hospital and the New Academic Affiliation Agreement. Section 28 of the New Lease recognizes that the New Lease is executed and delivered in the Commonwealth and subject to its laws. Section 23.6 of the New Academic Affiliation Agreement recognizes that the agreement is deemed to have been entered into in the Commonwealth of Kentucky. Each of these agreements is subject to a termination for convenience under KAR 200 KAR 5:312.

Nonetheless, neither of the proposed agreements expressly identifies the Commonwealth's power to terminate for convenience, as required by 200 KAR 5:312, Section 3. Further, it should be made clear that a termination for convenience of the Commonwealth is not subject to "Conflict Resolution" process set forth in the New Academic Affiliation Agreement.

With regard to the Sponsorship Agreement, the Secretary of Finance and Administration Cabinet is not proposed as a signatory to the agreement. However, by virtue of the University of Louisville's participation, 200 KAR 5:312 is a power exercised by the purchasing officer of the University of Louisville and is also likely applicable to the Sponsorship Agreement. It should be made express in the Sponsorship Agreement that a termination for convenience is a right reserved to the University of Louisville. Further, the provisions should state that the exercise of the right is not subject to the "Dispute Resolution Process" in the Sponsorship Agreement.

E. Constitutional Issues under the United States and Kentucky Constitutions

Among the Consolidation Parties, CHI Kentucky, Inc., CHI, JHSMH and Saint Joseph Health System, Inc. are subject to the Ethical and Religious



Directives for Catholic Health Care Services (ERDs).[26] UMC, as a non-religious stand-alone entity is not. However, UMC has agreed contractually not to perform certain procedures that would be prohibited under certain ethical and religious directives. (Schedule 1 of Common Purpose Agreement, attached as Exhibit M) As a result, the following medical procedures may not be performed at the Hospital: elective (direct) abortions (not presently performed at University Hospital), delivery of contraceptives, sterilizations (e.g. tubal ligations), fertility treatments and euthanasia (not permitted under Kentucky law). These restrictions on the performance of certain medical procedures at the Hospital, a public asset, have raised constitutional questions: namely, whether such restrictions of services at a public hospital violate the Establishment Clause of the United States Constitution, as it relates to excessive entanglement between state and religion; and Section 5 of the Kentucky Constitution, prohibiting a preference by law to any particular religious sect, society or denomination.

The First Amendment's Establishment Clause provides that, "Congress shall make no law respecting an establishment of religion." The Supreme Court has evaluated Establishment Clause challenges based upon a test developed in Lemon v. Kurtzman, 403 U.S. 602 (1979), holding that government action violates the Establishment Clause if it has the principal purpose or primary effect of advancing religion or fosters an excessive entanglement with religion. In Larson v. Valente, 456 U.S. 228, 244 (1982), the U.S. Supreme Court interpreted the Establishment Clause to also contain a neutrality mandate, holding "The government may not favor one religion over another, or religion over irreligion."

Opponents of the proposed merger argue that approval of the transaction will have the impermissible effect of advancing religion by authorizing and requiring a public, state-owned hospital to be governed by the Catholic Church's religious directives. Opponents further allege that the denial of certain services by the Hospital due to religious doctrine is a violation of the neutrality mandate of the Establishment Clause.

Proponents of the merger present the alternate perspective that the proposed merger does not violate the Establishment Clause because neither the University of Louisville nor UMC will technically be bound by the ERDs, the merger has legitimate secular purposes, and the merger does not foster an excessive entanglement between government and religion. These arguments rely on the premise that UMC is not a public entity, an issue that has not yet been decided by a court of law.

Further complicating this issue is the evolution of the University's explanation of to what degree the Hospital will be subject to the ERDs. On June 14, 2011 the Dean of the University's School of Medicine stated that the University had "made a promise that we'll respect the Ethical and Religious Directives of the Catholic Church." On June 30, 2011 the CEO of UMC stated that the "partners have committed to honoring the rich academic heritage of UofL (and) Jewish Hospital and religious heritages, including the Ethical and Religious Directives of the Catholic Church." Then in October of 2011, the parties to the proposed consolidation revised their public position on the ERDs by stating that the Hospital "will not become a Catholic hospital, and will not be required to follow the ERDs. By contractual agreement, elective sterilizations, elective abortions and euthanasia will not be performed."[27] While this evolving explanation may represent an accurate description of the proposed legal structure of the consolidation, it has cast a cloud of vagueness and skepticism over the issue in the public eye.

The vagueness surrounding the ERD issue, as well as the proposed structure of the consolidation involving the University and the use of state assets may likely set the stage for a constitutional challenge of the consolidation. For these reasons, the Attorney General is not yet in a position to opine as to whether the proposed consolidation satisfies the United States and Kentucky Constitutions. This will ultimately be a matter for resolution by the courts. In any event, such litigation would undoubtedly be lengthy and would require the use of valuable state resources to defend.

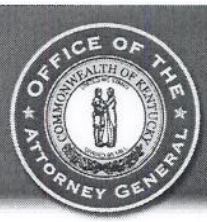
F. Open Records/Transparency

On October 6, 2011, the Office of the Attorney General issued 11-ORD-157 wherein it determined that UMC is a public agency for purposes of the Kentucky Open Records Act. (See Exhibit H) Pursuant to the decision, the OAG determined that UMC is a "public agency" pursuant to KRS 61.870(1)(j) because it is an "agency which is established and created, and is controlled by a public agency…" As such, the records of UMC are public and must be available for public inspection absent one of the exceptions to disclosure set forth in KRS 68.878(1)(c).

If the proposed consolidation transaction is completed, UMC will be controlled by KSN, in which the University of Louisville is only a minority Sponsor, i.e. sixteen percent. This change in control of UMC by the University of Louisville may arguably take UMC out of the definition of a "public agency" under KRS 68.870(1)(j). Access to the records of UMC, however, could still be obtained indirectly, but only if the University of Louisville, in its capacity as a Sponsor, obtains control of records and reports supplied by or on behalf of KSN.

Under Section 2.5 of the Sponsorship Agreement, KSN must deliver a copy of the audited financial statements to each Sponsor. The University of Louisville will also, under Section 2.2(A)(2)(b)(ii), be allowed to review and audit necessary books and records to determine if fee-for-service payments to CHI, in amount and methodologies, are consistent with those imposed with respect to other CHI wholly-owned subsidiaries. Additionally, under the New Academic Affiliation Agreement, the Academic Medical Center Committee (which will be controlled by the University

26 http://www.usccb.org/upload/Ethical-Religious-Directives-Catholic-Health-Care-Services-fifth-edition-2009.pdf
27 Howington, P. (Oct. 24, 2011), "Hospital merger stance softens," The Courier-Journal



of Louisville) will have a right to information regarding KSN's capital budgets, operating budgets, and strategic plans for the "New Teaching Hospital."

The loss of control of UMC, coupled with the absence of transparency provisions in the Transaction Documents, results in a clear loss of access by the public to documents related to a public asset, the Hospital. Prior to approving the transaction, the Commonwealth should ensure that the University of Louisville will receive all records and reports contemplated for transmittal under the agreements and any permitted record or report necessary for monitoring and supervising KSN and the New Teaching Hospital. Further, the Commonwealth should require the University of Louisville to expressly acknowledge that all such records shall be subject to the Kentucky Open Records Act.

G. Lending of the Credit of the Commonwealth

Section 177 of the Kentucky Constitution provides: "The credit of the Commonwealth shall not be given, pledged or loaned to any individual, company, corporation or association, municipality, or political subdivision of the State; nor shall the Commonwealth become an owner or stockholder in, nor make donation to, any company, association or corporation; nor shall the Commonwealth construct a railroad or other highway."

Section 2.4 of the Sponsorship Agreement states that no Sponsor will be obligated to make any additional contributions to the net assets of KSN nor fund any capital assessments, make any loans to, investments or other advances to KSN. Additional contributions are only authorized and required upon the unanimous agreement of the Sponsors. Furthermore, the Section 4.2(A)(6) of the Sponsorship Agreement confirms that unanimous agreement of the Sponsors is necessary for the approval of any additional contributions of capital. Finally, because KSN is a nonprofit corporation, it does not have any shares of capital stock.

While the Commonwealth and the University are beneficiaries of assets dedicated to a charitable or public purpose, neither the Commonwealth nor the University has an ownership interest in KSN as prohibited by Section 177 of the Kentucky Constitution. The implication of Section 177 was an initial concern, principally arising in connection with the University's role as a Sponsor and in a potential unwind scenario. However the parties have addressed the concern and the Attorney General is satisfied that the proposed consolidation does not violate Section 177 of the Kentucky Constitution on its face.

H. Protection of Charitable Assets

1. Presently Held Charitable Assets

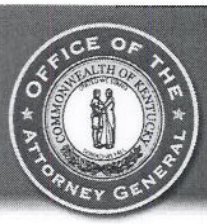
With respect to presently held donations or charitable gifts made to or for the benefit of the "University of Louisville Hospital," UMC does not hold such donations or charitable gifts. In fact, in December of 2009, UMC dissolved its related charitable foundation. Instead, the University of Louisville Foundation is the entity that holds endowments and other restricted gifts in favor of "University of Louisville Hospital" or UMC. Given that the University of Louisville Foundation is not a party to or beneficiary of the proposed consolidation, the proposed transaction does not by itself pose a risk that charitable contributions made for the benefit of the Hospital and held by the University of Louisville Foundation would be used contrary to Kentucky laws relating to charitable assets.

With respect to UMC specifically, because UMC is a Kentucky nonprofit with Section 501(c)(3) status under the Internal Revenue Code, all of its assets are charitable assets. Consequently, UMC many not convert its assets to a non-charitable use. Based on the Transaction Documents, the proposed transaction does not appear to run afoul of this prohibition.

2. Distributions to Sponsors

The charitable and state assets proposed to be contributed by UMC to the consolidation may not be misdirected or otherwise applied in a manner inconsistent with their charitable or public purposes. On this point, there is the potential for misdirection under the proposed Sponsorship Agreement, namely that the Sponsors have the unrestricted right to the assets of KSN, including those of UMC.

Section 2.2(B)(1) of the proposed Sponsorship Agreement permits the Sponsors, by unanimous consent and without the approval of the board of directors of KSN, to approve payments by KSN to the Sponsors. Such payments to the Sponsors would have to be consistent with the original charitable purpose of assets and could not be distributions in the form of dividends to the Sponsors. If not, such payments could potentially violate Kentucky law, similar to what occurred with University Health Care, Inc. dba Passport Health Plan. While the terms of the proposed Sponsorship Agreement relating to the foregoing distributions appear permissible on their face, given the risk of improper distributions, it is important that the Sponsors exercise caution in such distributions. It is also essential that the University and the Commonwealth have the ability to monitor and scrutinize such distributions to ensure legal compliance and continued use of the assets consistent with their charitable and public purposes.



3. Additional Payments

In addition to the above-described distributions, the proposed Sponsorship Agreement provides for "Mission Payments" under Section 2.2(A)(1) and fee-for-service payments under Section 2.2(A)(2). These payments do not, on their face, raise concerns except for the "Capital Resource Pool" payments characterized as fee-for-service payments. Although characterized as a fee-for-service, the "Capital Resource Pool" payment is a transfer of assets for undesignated purposes. In simple terms, if KSN transfers cash or other assets out as a "Capital Resource Payment," it is very difficult, if not impossible, to determine the consideration returned to KSN for such payment. Such payments raise a concern for a number of reasons. First, it could result in a conversion of the original purpose of a charitable asset, e.g. an asset of UMC, to a purpose different than that for which it was originally dedicated. Second, from a broader financial perspective, such payments could result in a reduction in the net revenues potentially available to be distributed to the Sponsors. Third, it raises the issue of assets or revenues potentially being transferred out of Kentucky without a corresponding identifiable benefit in return.

I. Potential Dilution of Sponsorship Percentage

In addition to monitoring the ongoing use of the Hospital consistent with its public mission, the University and the Commonwealth must be able to ensure that its interest in the Hospital is not diluted. On this note, a change in the University's Membership Interest Percentage can potentially take place as set forth in the Sponsorship Agreement.

Under the Sponsorship Agreement, no Sponsor is obligated to make any additional contributions to the net assets of KSN; and there is no obligation for the Sponsors to make loans, advances, investments, or pay capital assessments to KSN. However, if the Sponsors unanimously agree to make additional contributions to the net assets of KSN under Section 2.4 of the Sponsorship Agreement, and a Sponsor fails to make its pro rata contribution, then that Sponsor is in breach of the Agreement. The Sponsor's Membership Interest Percentage would then be adjusted to a new percentage equal to the sum of the Fair Value of the Sponsor's Membership Interest Percentage as of the date the additional contribution was due plus the amount of any Additional Contribution that was made by the Sponsor (including any additional amount of the Additional Contributions made on behalf of the Noncontributing Sponsor) divided by the sum of the Fair Value of KSN as of such date plus the aggregate amount of such Additional Contributions made by all of the Sponsors.

In addition, Article XI of the Sponsorship Agreement permits KSN to satisfy all or any amounts owed by a breaching Sponsor to KSN, as determined by judgment of a court of competent jurisdiction, by reduction of the breaching Sponsor's Membership Interest Percentage. The reduction formula is the sum of the Fair Value of the breaching Sponsor's Membership Interest as of the date the amount first became due and payable less the amount owed by the breaching Sponsor divided by the Fair Value of the Network Entity as of the Due Date reduced by the amount owed. The remaining Sponsors' Membership Interest Percentages are proportionately increased.

While the foregoing issue is significant, the fact that the Sponsorship agreement requires unanimous agreement of the Sponsors before an additional contribution may be required mitigates the concern. Nonetheless, great caution should be exercised by the University in considering whether to ever agree to such an additional contribution. Further, given the fact that the Hospital is a public asset, the Commonwealth should have an oversight role in such a decision.

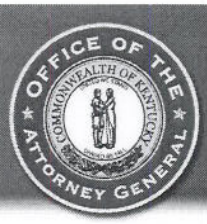
J. Restricted Services/Agreement to Not Compete

Article XI of the Sponsorship Agreement contains numerous restrictive covenants and limitations on services which would compete with KSN. As such, if the consolidation is consummated, the University would be limited in the types of medical services it provides, or desire to provide, outside of KSN.

Under Section 6.1(A) of the Sponsorship Agreement, the Sponsors shall not cause directly or indirectly competition with the services or products of KSN. The Restricted Services prohibition applies to the entirety of the Commonwealth of Kentucky except for Boone, Kenton, and Campbell Counties. The Restricted Services prohibition of Section 6.1(A) also applies to the Indiana counties of Floyd, Clark, and Scott (along with the entirety of the Commonwealth of Kentucky except for Boone, Kenton, and Campbell Counties, the "Restricted Territory").

Section 6.1(B) of the Sponsorship Agreement references an Exhibit E that contains activities that are not deemed Restricted Services. For the University, Exhibit E includes, and therefore does not prohibit, the University of Louisville Family Health Center, University of Louisville Physicians, Inc. (ULP), and University Physicians Associates, Inc. (UPA). With regard to ULP and UPA, which are not signatories to the Sponsorship Agreement, the University is under a duty to use its best efforts to use its influence and control to prevent ULP and UPA from competing with KSN in a manner that would violate the Restrictive Covenants section of the Sponsorship Agreement if the activities were conducted directly by the University School of Medicine.

Section 6.1(B) of Sponsorship Agreement also permits the University to make charitable or eleemosynary grants provided that the conditions as-



sociated with the grants makes it a requirement that the grants not be used by the recipients to engage directly or indirectly in Restricted Services in the Restricted Territory as well as any activities of the University other than the clinical activities of the School of Medicine.

Under Section 6.1(C) of the Sponsorship Agreement, each Sponsor (including related entities) that desire to engage in Restricted Services in the Restricted Territory must notify KSN, which will have a right of first refusal regarding the provision of service. If the University is mandated by state law to engage in activities that would be Restricted Activities in the Restricted Territory, Section 6.3(E) provides KSN with an option to engage in those activities on the University's behalf. Further, KSN has a right of first refusal under Section 6.4 for Subsequent Acquisitions by Sponsors.

Under Section 6.1(D) of the Sponsorship Agreement, CHI shall not directly or indirectly allow any entity other than KSN to engage in any of the Restricted Services in Boone, Kenton, or Campbell counties without the consent of the University and JHHS except that it may continue a joint venture, TriHealth, Inc., in a manner consistent with a current contract. Per Section 6.2, KSN cannot engage in Restricted Services in these counties without the consent of TriHealth, Inc., if it would violate the contractual arrangement involving TriHealth. For these three Kentucky counties, under 6.1(E), there is a KSN right of first refusal similar to the right under Section 6.1(C). If the University or JHHS desires to engage in Restricted Services in Boone, Kenton or Campbell counties, it must notify KSN of the material terms and conditions regarding the provision of the Restricted Services, and KSN may elect to provide the services in these counties.

Section 6.3 of the Sponsorship Agreement contains special provisions regarding academic affiliations; however, before the University may take any action under this Section, it must provide notice to the other Sponsors who may invoke the dispute resolution process the Sponsorship Agreement. Per Section 6.3(A), if KSN fails to provide material financial support or otherwise ceases to support a material clinical service at the Teaching Hospital Facilities that is reasonably necessary for maintaining Accreditation for the School of Medicine or for the School to be a Competitive School of Medicine, the University may affiliate with entities other than KSN at facilities other than KSN facilities for providing teaching and education opportunities within such a service line. Under Section 6.3(B), neither CHI nor JHHS may enter into academic affiliations with schools of medicine at the University of Kentucky, Indiana University, Washington University, the University of Tennessee, or Vanderbilt University resulting in the provision of residency, teaching, or other academic programs in the Affiliation Restriction Territory or the Indiana counties of Spence and Warrick. Section 6.3(B) does not prevent CHI or JHHS from merging with or acquiring any entities that have an existing academic affiliation with parties other than the University of Louisville.

Section 6.3(D) addresses the Termination or Nonrenewal of the New Academic Affiliation Agreement. Basically, 6.3(D)(1), prohibits the University from entering into an similar academic affiliation agreement during the Applicable Period (defined below). The University may enter into an agreement for the management of the operations of the Teaching Hospital Facilities or an academic affiliation agreement with the entity that acquires the Teaching Hospital Business. With regard to KSN, Section 6.3(D)(2) provides that KSN will not enter into a similar academic affiliation agreement with any school of medicine within the Affiliation Restriction Territory during the Applicable Period. Section 6.3(D)(3) functions to prohibit JHHS and the University from entering into an academic affiliation agreement for similar services and programs, an agreement for co-ownership, management, or other joint venture of any of their respective health care facilities, or an agreement where one party supports another during the Applicable Period.

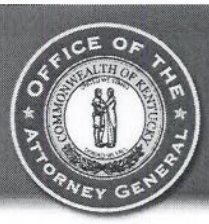
There are two different Applicable Period formulas for Section 6.3. If the termination of the New Academic Affiliation Agreement results from a KSN cause, the Applicable Period is the longer of 12 months following the commencement of the Transition Period (the termination or expiration of the Agreement) or completion of the Transition Period. Thus, for the first formula, there is a twelve month minimum. If the termination results from a University breach or a nonrenewal by the University, the Applicable Period is the longer of 24 months following the commencement of the Transition Period or the completion of the Transition Period.

VI. ISSUES OF PUBLIC POLICY

While the principal scope of this review is focused on legal issues arising out of the proposed consolidation, we must also identify a few of the many public policy issues at hand.

A. Ethical and Religious Directives/Reduced Level of Service

The Consolidation Parties and the Sponsors have pointed out that only the facilities currently identified as "Catholic" will be "Catholic" following the proposed consolidation. As such, only those Catholic entities will be completely subject to the Ethical and Religious Directives of the Roman Catholic Church (ERDs). Specifically, according to the Transaction Documents, neither UMC nor the Hospital will be identified or treated as a "Catholic" institution. (Common Purpose Agreement, Sections 1.2, 1.3 and 1.4, Exhibit M; Sponsorship Agreement, Section 5.3, Exhibit C) Nonetheless, UMC and the Hospital have contractually agreed not to perform certain procedures that would be prohibited by certain ethical and religious directives, including elective sterilizations, elective abortions and euthanasia. (See discussion of Establishment Clause above) (See



Schedule 1 of the Common Purpose Agreement, Exhibit M; Sponsorship Agreement, Section 5.3, Exhibit C) The Hospital does not practice elective abortions or euthanasia now. Although Contraceptives may still be prescribed in the event of consolidation, they will no longer be dispensed by the Hospital pharmacy.

Regarding sterilizations, the University has made arrangements for the restricted services to be provided outside of KSN facilities if the consolidation is approved. The University of Louisville and Baptist East Hospital have reportedly agreed that University of Louisville physicians will provide reproductive services, including tubal ligations, restricted by the ERDs at Baptist East Hospital, and the University of Louisville will pay Baptist East Hospital for use of the facility to provide the services. (See letter summarizing the agreement attached as Exhibit N)

Regardless of the reason, certain services will no longer be available at the Hospital, notably sterilizations, including tubal ligations, and delivery of contraceptives. This represents a material change in the level of service at the historically public Hospital, which is the principal provider of indigent care for the Louisville region.

B. Control of State Assets

The issue of ongoing control and protection of a state asset, i.e. the Hospital, arises principally out of the proposed control structure of KSN. As discussed above, the current operator of the Hospital is UMC. UMC is effectively controlled by the University of Louisville and the operation of the Hospital is governed by the current Affiliation Agreement. Pursuant to the proposed consolidation, UMC will remain as a corporate entity and will also be the corporate entity named as the operator of the Hospital in the New Academic Affiliation Agreement. However, if the proposed consolidation is completed, UMC will be wholly controlled by KSN. KSN will be controlled by CHI (the seventy percent sponsor, while the University of Louisville and JHHS will only have minority sponsorship percentages of sixteen percent and fourteen percent respectively).

In effect, UMC, the entity holding the lease rights and the right to operate the Hospital, a public asset, will be majority controlled by a private corporate entity subject to the ERDs. By holding a majority position in KSN, CHI will effectively control the scope of medical services, budget, and operations of KSN and the Hospital if the transaction is approved, instead of the University of Louisville.

While the University of Louisville will have a measure of input into the operations of KSN and the New Teaching Hospital, CHI is in firm control of both. Section 3.1 of the Sponsorship Agreement provides CHI with the ability to appoint a majority of KSN Board Members. Under Section 4.2(C) of the Sponsorship Agreement, CHI reserves the power to approve annual and long-term capital budgets of KSN. Under Section 4.4 of the New Academic Affiliation Agreement, the Academic Medical Center Committee has input on the development of capital budgets, operating budgets, and strategic plans for the New Teaching Hospital; however, the Board of KSN does not have to follow the recommendations. Under Section 8.1 of the New Academic Affiliation Agreement, KSN is responsible for the operations of the New Teaching Hospital and develops its operating budget.

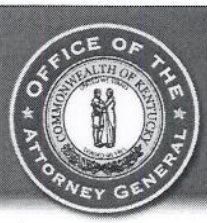
From any perspective, the proposed arrangement represents a significant erosion of the University and Commonwealth's control over a major public asset.

V. CONCLUSION & RECOMMENDATIONS

The most fundamental fact at hand is that the University of Louisville Hospital is a public asset, dedicated to the public purpose of providing healthcare, particularly providing healthcare to the indigent. Since 1979, the Hospital has been owned by the Commonwealth of Kentucky for the use and benefit of the University of Louisville. The Commonwealth and the University presently contract with UMC to operate the Hospital consistent with and in furtherance of its long standing mission of being the safety net hospital for the greater Louisville community and beyond. UMC's right to operate the Hospital is memorialized in the Affiliation Agreement and related Lease.

Notably, UMC, the University and the Commonwealth of Kentucky, acting through the Governor and the Secretary of the Finance and Administration Cabinet, are all parties to the Affiliation Agreement and related Lease. It is for this reason that any modification of the Affiliation Agreement and related Lease requires the approval of the Governor. In considering whether to approve or disapprove of the proposed modifications as evidenced by the New Academic Affiliation Agreement and the New Lease, the Governor has the obligation to protect public assets and ensure that such assets continue to be used for the purposes for which they are dedicated.

It is indisputable that the Commonwealth of Kentucky is a party to the present Affiliation Agreement and Lease, and is a necessary party to the proposed New Academic Affiliation Agreement and New Lease. In addition, the Commonwealth, as well as the University, has fiduciary obligations to protect public assets. Nonetheless, the University of Louisville, presumed to negotiate the disposition and long term use of a clear public asset in an unprecedented venture rife with complexities and permanent implications for the future. The University did this without fully or timely engaging or consulting with the appropriate agencies of the Commonwealth, notably the office of the Governor and the Finance and Administration Cabinet.



On November 11, 2010, the University of Louisville Board of Trustees first authorized President James R. Ramsey to execute a letter of intent regarding the proposed consolidation. The minutes from that day reflect that the University had been in discussions with CHI, JHHS/JHSMH and UMC for "approximately a year" before then.[28] Yet, the University did not seek the Commonwealth's approval until after June of 2011, and only then after the Attorney General and the Governor raised the issue. In light of the Affiliation Agreement, Lease and the important public asset at issue, i.e. the Hospital, the Governor and the Secretary of the Finance and Administration Cabinet should have been involved in the negotiations much earlier.

In addition to the foregoing issues, the proposed consolidation raises significant legal and policy issues, as set forth above and summarized below along with, in some cases, associated recommendations.

- Acquisition and Disposition of State Assets. The history of the operation of the Hospital and the proposed New Affiliation Agreement trigger the provisions of KRS Ch. 45A, KRS Ch. 164A, and the University's Policies and Procedures. Based on a review of the Transaction Documents and Board of Trustee minutes, and particularly the minutes from November 11, 2010[29] and June 9, 2011[30], it does not appear that the University of Louisville has yet complied with these applicable statutory provisions. Further, it is unclear whether the applicable statutes can be complied with at all as it relates to a potential future forced acquisition of assets in addition to the Hospital in the event of an unwind.

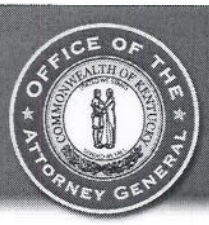
- Effects and Risks of an Unwind. The largest risk associated with an unwind of the proposed consolidation is financial in nature. Namely, in the event of an unwind, the University would be required, under certain circumstances, to re-purchase not only the Hospital, but also the downtown Jewish Hospital and Frazier Rehab, and could be also be required to purchase all of KSN's assets located in Jefferson County. While the University's sponsorship interest may, in large part, offset as a credit the purchase of the Hospital, it likely would not cover the price of the additional facilities. It does not appear in any of the Transaction Documents, or elsewhere, that the University has made any plan for such contingent liabilities. Further, it is conceivable, that if the University is faced with financing the acquisition of significant assets beyond the Hospital, it may turn to the Commonwealth to assist. This risk for the Commonwealth, especially since it was not involved in the negotiations in advance, may not be in the public's interest. It would be advisable for the University to make better contingency plans to address a possible major financial obligation in connection with a potential re-purchase and operation of the Hospital and additional assets.

- Termination of Contracts Pursuant to 200 KAR 5:312. Pursuant to 200 KAR 5:312, the New Academic Affiliation Agreement, the New Lease, the Sponsorship, as well as any other agreement to which the Commonwealth or the University are a party, should be expressly acknowledged to be subject to 200 KAR 5:312 allowing termination if the applicable purchasing officer determines that it is in the Commonwealth's best interest.

- Constitutional Issues under the United States and Kentucky Constitutions. Because the Sponsors and Consolidation Parties include religiously affiliated organizations, including JHHS, CHI Kentucky, Inc., CHI, JHSMH and Saint Joseph Health System, Inc., and, with the exception of JHHS, those entities are subject to the Ethical and Religious Directives for Catholic Health Care Services, significant constitutional issues have been raised, including without limitation the Establishment Clause of the United States Constitution. Given the uncertain status of this issue in the Courts and the unique nature of the proposed consolidation, the Office of the Attorney General is not able to presently render a conclusive opinion to the constitutionality of the proposed transaction. Nonetheless, if litigation arises, it will undoubtedly be protracted and expensive.

- Open Records/Transparency. If the proposed consolidation transaction is completed, UMC may no longer meet the definition of a "public agency" under KRS 68.870(1)(j). Access to the records of UMC and the Hospital, however, could still be obtained indirectly, but only if the University of Louisville obtains control of records and reports supplied by or on behalf of KSN. The loss of control of UMC by the University, coupled with the absence of transparency provisions in the Transaction Documents, results in a clear loss of access by the Commonwealth and public to documents related to a public asset, the Hospital. Prior to approving the transaction, the Commonwealth should ensure that the University of Louisville will receive all records and reports contemplated for transmittal under the agreements and any permitted record or report necessary for monitoring and supervising

28 http://louisville.edu/president/trustees/minutes/2010/BOTmin11-11-10.pdf
29 http://louisville.edu/president/trustees/minutes/2010/BOTmin11-11-10.pdf
30 http://louisville.edu/president/trustees/minutes/2011/BOT%20minutes%206-8-11.pdf



KSN and the New Teaching Hospital, and that such records are acknowledged to be subject to the Kentucky Open Records Act.

- Protection of Charitable Assets. The proposed Sponsorship Agreement permits the Sponsors, by unanimous consent and without the approval of the board of directors of KSN, to approve payments by KSN to the Sponsors. Such payments to the Sponsors would have to be consistent with the original charitable purpose of assets and could not be distributions in the form of dividends to the Sponsors. While the terms of the proposed Sponsorship Agreement relating to the foregoing distributions appear permissible on their face, given the risk of improper distributions, it is important that the Sponsors exercise caution in such distributions. The "Capital Resource Pool" payments characterized as fee-for-service payments under the Sponsorship Agreement also raise some concern. Although characterized as a fee-for-service, the "Capital Resource Pool" payment is a transfer of assets for undesignated purposes. Such payments raise a concern for a number of reasons. First, it could result in a conversion of the original purpose of a charitable asset. Second, from a broader financial perspective, such payments could result in a reduction in the net revenues potentially available to be distributed to the Sponsors. Third, it raises the issue of assets or revenues potentially being transferred out of Kentucky without a corresponding identifiable benefit in return.

  If the proposed consolidation is approved and goes forward, the Commonwealth and the University should require KSN to deliver to the Finance and Administration Cabinet audited and unconsolidated financial statements for both UMC and KSN. Further, the University and the Commonwealth would need to diligently monitor the operations of KSN to ensure the continued protection of the charitable assets.

- Restricted Services/Agreement to Not Compete. Section 6 of the Sponsorship Agreement contains numerous and significant restrictions on what services the University may provide outside of KSN, as set forth above. Most notable, is Section 6.3 which provides that the University may affiliate with another entity if KSN fails to provide material financial support or otherwise ceases to support a material clinical service at the Teaching Hospital Facilities that is reasonably necessary for maintaining Accreditation for the School of Medicine or for the School to be a Competitive School of Medicine. There is some concern regarding the sufficiency of the remedy for KSN's failure to financially support the Teaching Hospital in a manner necessary to maintain accreditation. This issue may require further explanation.

The proposed consolidation of Jewish Hospital Healthcare Services, Inc., CHI Kentucky, Inc., Catholic Health Initiatives, University Medical Center, Inc., Jewish Hospital & St. Mary's Healthcare, Inc., Flaget Healthcare, Inc., Saint Joseph Health System, Inc., and JH Properties, Inc. to create a statewide network healthcare entity sponsored by Catholic Health Initiatives, Jewish Hospital Healthcare Services, Inc. and the University of Louisville, raises unprecedented and complex legal and policy issues. While some of the legal and policy issues have been addressed by the parties, many remain unresolved. For these reasons, it is the opinion of the Attorney General that the Commonwealth of Kentucky, acting through the Governor and the Secretary of the Finance and Administration Cabinet, should not at this time enter into the proposed New Academic Affiliation Agreement and New Lease.