



# **An Assessment of Options for the Board of Trustees of Boone County Hospital**

*July 31, 2006*

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## I. INTRODUCTION AND PROJECT FRAMEWORK

**Introduction.** Since September 1, 1988, Boone Hospital Center (“BHC” or “the hospital”) has been managed and operated under a lease agreement between the Board of Trustees of Boone County Hospital (“the Trustees”) and Christian Health Services (“CH Allied Services, Inc.” or “CHAS”). In 1993, CHAS merged with Barnes Hospital and Jewish Hospital to form BJC Healthcare. In 2000, as the result of negotiations and effective January 1, 2001 the lease agreement was substantially changed. The current agreement provides, among other provisions, that the Trustees can terminate the lease at any time during calendar year 2006 with the termination effective on the same calendar day two years later, in 2008.

The Trustees are a component unit of Boone County, Missouri and are charged with operating the hospital. The Trustees serve as lessor for BHC and share in certain hospital management and oversight responsibilities as governed by the lease agreement.

The Trustees retained The Lewin Group to provide an independent assessment of the lease agreement, to identify options for consideration, and to analyze the options. The Trustees’ decision to study the current relationship with BJC results from several factors:

- The Trustees have a fiduciary responsibility to Boone County and to BHC and are assessing the lease relationship in that context.
- Questions have been raised regarding the fairness of the flow of funds to BJC, the Trustees, and the County under the current lease agreement.
- Uncertainty regarding the future relationship between the Trustees and BJC has the potential to affect BHC operations, e.g. the ability of the hospital to recruit staff successfully and BJC’s willingness to support long range plans and capital investment at the hospital.
- The healthcare market and needs in Boone County are subject to rapid change and the Trustees want to assure that the hospital is performing well for the communities and stakeholders that rely on the services provided.

To conduct the assessment, The Lewin Group team performed the following tasks:

- Conducted interviews with the Trustees and with BHC managers in Columbia, Missouri.
- Held several conversations with BJC leadership.
- Developed a framework to guide the study.
- Reviewed the lease agreements (pre and post-January 1, 2001).
- Reviewed numerous documents regarding the negotiation process that led to the current lease.

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- Reviewed market and strategic studies for the Boone County area.
  - Reviewed the terms of other leases between health systems and public and not-for-profit hospital boards.
  - Analyzed the historical and projected financial performance of BHC and the flow of funds between BHC and BJC, and between BHC and the Trustees.
  - Considered the services provided by BJC to Boone County Hospital.
  - Considered options for the future governance and management of the hospital.
  - Prepared this report that documents the results of the assessment.

**Project Framework.** To perform the assessment, The Lewin Group team asked two key questions:

1. Does Boone Hospital Center *need* to be leased?
2. Is the current lease *fair* to the Trustees and the County?

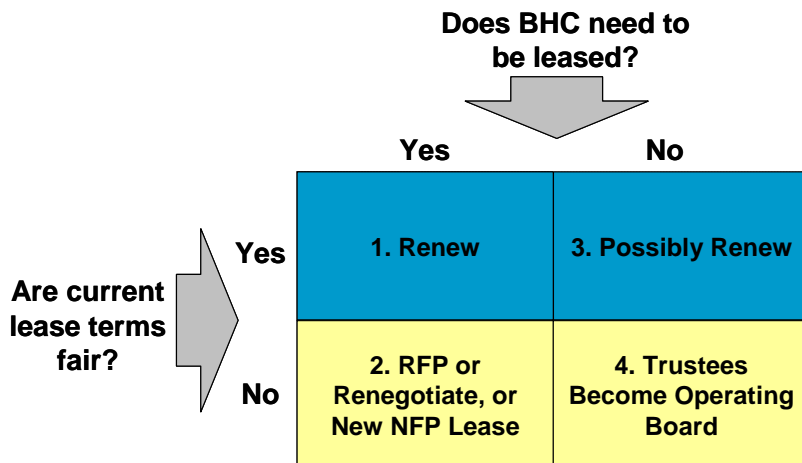
We approached addressing the first question by examining the following issues:

- Are **market and financial risks** facing BHC high? If so, then leasing the hospital would moderate the financial exposure of the Trustees and the County to potential future challenges in operating the hospital.
- Does a lease structure provide the Trustees and the hospital with important **legal protections**? For example, if the Trustees become the operating Board for the hospital, would Missouri “sunshine laws” make it difficult for BHC to operate in an increasingly competitive environment?
- Does a lease structure provide the hospital with valuable **operational flexibility**? For example, if the Trustees again became the operating Board for the hospital, would the hospital be subject to County personnel and purchasing requirements, and would that affect BHC’s ability to operate efficiently?
- Do the Trustees need the **services** that are provided by multi-hospital systems? If so, then leasing the hospital to a multi-hospital organization like BJC could remain a valuable option.
- Does leasing provide better BHC **oversight**? If a partner organization provides incremental and valuable insights that enhance governance and accountability, then a lease structure can provide value to the hospital.

We approached addressing the second question by examining (1) the services provided by BJC to BHC and the value exchanged between the parties and (2) the net cash flows to the Trustees and County from the current arrangement versus other alternatives.

Answers to the above two questions can guide selection of the most appropriate option or strategy for the future management and governance of the hospital:

Figure 1: Project Framework



The above framework suggests that:

1. If the hospital *needs* to be leased and if the current lease terms are judged to be *fair*, then **renewal** of the current lease under substantially the same provisions would be advised.
2. If the hospital and the Trustees would benefit from a lease structure but the current lease is determined not to be *fair*, then the Trustees could issue a **Request for Proposals** to obtain a new lease arrangement or seek to renegotiate the current terms.
3. If the hospital does not *need* to be leased but the current terms are reasonable, then the Trustees could choose to **continue with the lease** because the arrangement is *fair* to the parties.
4. If the hospital does not *need* to be leased and the current terms are *unfair*, then the Trustees could consider becoming the **operating board** for the hospital, through directly hiring a CEO for the facility or engaging a management organization under contract.

The options considered during the study thus are (1) to renew the lease under substantially the same provisions, (2) issue a Request for Proposals or renegotiate the lease terms, or (3) have the Trustees become the operating board for BHC. A fourth option also was identified and assessed. Under that option, a new, local board comprised of community representatives would form a new not-for-profit corporate entity that would lease BHC from the Trustees. Under that alternative, BHC would be operated by representatives of the community in and around Boone County.

Throughout the discussion, “current lease” refers to the lease now in effect between the parties that was substantially amended in 2000 and effective January 1, 2001.

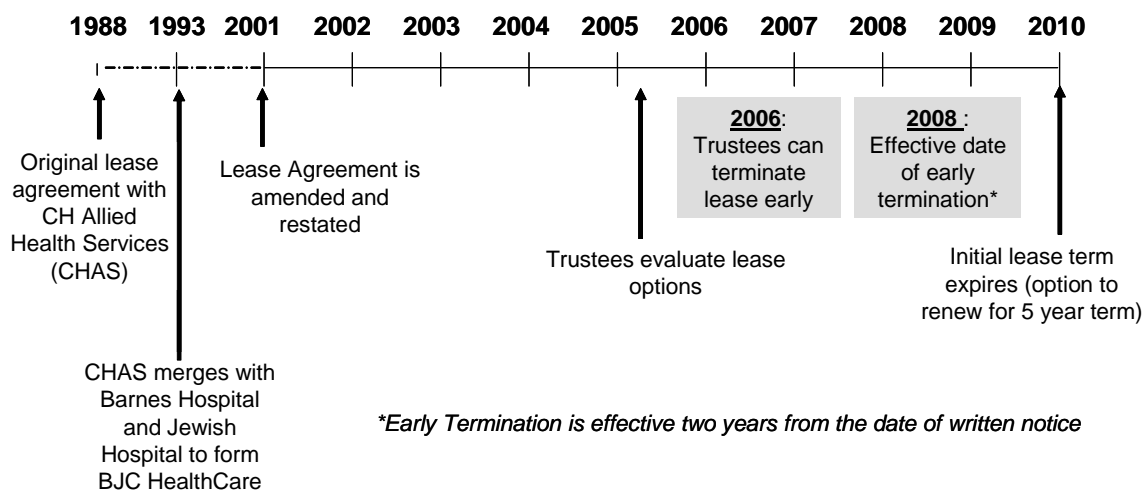
## II. CONTEXT FOR RE-CONSIDERING THE LEASE AGREEMENT

**BHC Characteristics and Recent Timeline of Corporate Events.** Boone Hospital Center is a 375-bed, regional referral center that provides a wide range of services for people in 25 mid-Missouri counties. The hospital operates several Centers of Excellence, including cardiology, neurology, oncology, surgical services, obstetrics, and numerous other specialty programs. The hospital maintains a 24-hour emergency room, with a hospital-based ambulance service and a helipad.

BHC has a rich history of community service, and offers programs ranging from education and disease prevention to technologically-advanced services. The hospital has grown through the years into a full-service medical center where private physicians who are not principally affiliated with University Hospital (part of University of Missouri Health Care, or “UMHC”) or Columbia Regional Hospital (now affiliated with UMHC) practice in Columbia.

BHC was operated as a county hospital until 1988. For several reasons, in the late 1980s the Trustees decided to lease the hospital and after a competitive process selected CH Allied Services, Inc., (“CHAS”) a Missouri not-for-profit corporation as lessee. Figure 2 portrays a timeline of major corporate events affecting BHC – beginning with the lease with CHAS that became effective on August 16, 1988 – through the scheduled end of the current lease arrangement.

Figure 2: Timeline



Source: Lewin analysis of leases and other documents.

The Trustees had several reasons for entering into the original lease with CHAS. One fundamental view was that county ownership was challenging the ability of the hospital to compete successfully. Missouri “sunshine laws” placed sensitive documents in the public domain. Constraints were placed on the hospital’s ability to locate programs in other counties –

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programs that were viewed as important to maintaining referrals and meeting needs in those areas. Concerns were raised about the ability of the county hospital to partner effectively with physicians.

At that time, the hospital also required subsidization from Boone County property tax resources. BHC faced financial and competitive pressures from Columbia Regional Hospital and the growing presence of managed care plans in the region. The Medicare program recently had fully implemented a new inpatient Prospective Payment System for reimbursement and industry observers were raising concerns about the impact of the new payment approach on hospital financial viability. The Trustees believed that affiliating with a larger hospital system would maintain and possibly improve BHC's reputation, solidify the hospital's market position, and help the hospital address financial pressures. With most public hospitals requiring growing financial support from locally generated tax resources, leasing the hospital was viewed as a way to insulate Boone County from a potentially growing subsidy requirement.

CHAS merged with Barnes Hospital and Jewish Hospital in 1993 to form BJC HealthCare. The hospital was operated under the "original lease" until January 1, 2001. The original lease was renegotiated due to several concerns about the equity of the arrangement for the County. It was recognized during the 1999-2000 time period that the original lease was set to expire in a few years, and the Trustees believed it prudent to attempt to renegotiate the terms. There also were significant questions regarding the amount (if any) that would be due to CHAS/BJC upon the expiration of the original lease (for example, to reimburse the lessee for leasehold improvements). The Trustees and CHAS/BJC thus entered into discussions that culminated in the current lease for BHC.

**The 2001 Lease.** Six major provisions were changed in the new (and current) lease arrangement:

1. The Trustees agreed not to terminate the new lease under any circumstances prior to January 1, 2005, and leased the hospital to CHAS/BJC through December 31, 2010.
2. The Trustees obtained the right to terminate the lease early (and "without penalty" and "without cause") by notifying the lessee in writing on any day during calendar year 2006 of this decision. Lease termination would be effective two years from the date that notice is transmitted to the lessee. CHAS/BJC has the right to extend the lease for an additional five years if the Trustees do not exercise their early termination rights, if a material default has not occurred, and if it notifies the Trustees of that decision before December 31, 2008.
3. At lease end, all BHC assets are transferred to the Trustees, except for the hospital's cash balance which is split with the lessee (CHAS/BJC) at termination. At termination, all of these assets (including medical records) will be transferred to the Trustees without any payment to CHAS/BJC, and the lessee is precluded from removing any assets that have any salvage value (with the exception of BJC's trademarks, logos, and other specified intellectual property).
4. The original requirement that the lessee (CHAS/BJC) invest capital dollars in BHC was refined. As described further below, CHAS/BJC is required to invest 9 percent of BHC's

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revenue in capital items (e.g., buildings, medical technologies, and other equipment). The lease was refined to count the principal and interest payments on Trustee-approved debt used to benefit the hospital towards the 9 percent requirement.

5. The new lease also established a new “profit-split” or “cash-split” formula for the Trustees that has provided the Trustees with significantly more annual compensation than had been received prior to 2001.
6. The lease also increased the role of the Trustees in the governance of the BJC HealthCare system by providing that one BJC board member be a member of the Board of Trustees of Boone County Hospital.

**Summary of Lease Terms.** These new provisions represented major adjustments to the terms of the original lease. The current lease has provisions that establish the following<sup>1</sup>:

- Assuring that pensions for employees at the hospital are fully funded before the hospital is transferred back to the Trustees.
- Specifying what constitutes a “major default” and a “non-major default” by either of the parties to the agreement. “Major default” on the part of CHAS/BJC includes a permanent loss of the license to operate the hospital or to participate in the Medicare program, bankruptcy or insolvency filings not cured within 60 days, failure to make the minimum rental payments to the Trustees and/or Boone County, and failure to comply with the results of any needed arbitration proceedings.
- That CHAS/BJC is to reasonably cooperate with the Trustees to assure a transition on termination of the lease that would not result in any interruption of services.
- That the Trustees and the County receive the following funds on an annual basis:
  - A “minimum rental payment” equal to all debt service (principal and interest) on bond financings issued by the Trustees/County concerning the hospital.
  - A payment to the County of \$1.35 million, increased annually by the Consumer Price Index for All Urban Consumers, Columbia Missouri during the previous year.
  - Fifty percent of BHC’s net increase in cash and cash equivalents. If the net change in cash and cash equivalents is insufficient to cover BHC’s operating expenses, capital expenditures, and lease payments, then the Trustees are responsible for fifty percent of the shortfall.
- The Trustees are assured that the lessee will invest in BHC capital needs pursuant to the following formula: BJC is committed to expend no less than 9 percent of BHC net revenues (averaged over three years) on: capital expenditures and on debt service on bonds whose proceeds are used for capital expenditures at BHC. If BJC has not

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<sup>1</sup> The following points summarize lease provisions that The Lewin Group selected to highlight as important to the assessment. This does not represent a complete description of all lease terms.

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expended all of the dollars necessary to meet this requirement, then BJC is to transfer an amount equal to the unexpended amount to the Trustees upon lease termination.

- The Trustees are to be consulted regarding proposed capital improvements at BHC and, in the event of disagreement, will have a discretionary right to designate up to one percent of BHC net revenue for capital expenditures specified by the Trustees. The one-percent discretionary allocation increases to 2 percent during the last two years of the Term of the lease.
- That CHAS/BJC will receive the following compensation for operating BHC:
  - An annual payment of \$4.9 million in consideration of BJC providing various corporate services, including information system salaries and information system employment related costs of local BHC information system employees, also increased annually by the CPI. The corporate services to be provided by BJC include:

**Figure 3: Corporate Services Provided to BHC by BJC**

- Billing and compliance
- Managed Care Contracting
- Reimbursement Review and Consultation
- Government Affairs Support
- Charge Description Master (CDM) analysis
- Audit Services
- Risk management
- Legal Services
- In-House Communications
- Marketing
- Planning
- Physician Referral and Health Promotions
- Compensation Consultation (Human Resources)
- Employee health and Welfare
- Benefits Consultation
- Quality and Effectiveness
- Performance Improvement Initiative Support
- Information Services-Operations
- Telecommunications

Source: Amended and Restated Lease Agreement between The Board of Trustees of Boone County Hospital and CH Allied Services, Inc., January 2001.

- A payment to BJC of 3 percent of BHC net revenues as full compensation for management services.

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- Fifty percent of BHC's net increase in cash and cash equivalents. If the net change in cash and cash equivalents is insufficient to cover BHC's operating expenses, capital expenditures, and lease payments, then BJC is responsible for fifty percent of the shortfall.
  - Under the current lease, the Trustees have other rights and responsibilities, such as:
    - Appointment of one director to BJC's governing board and one member to all other boards and board committees with any oversight responsibilities relative to BHC operations.
    - CHAS/BJC is to consult with the Trustees 60 days prior to the elimination of any major clinical services (defined as a program that yields 5 percent or more of BHC's net revenue) or the relocation or outsourcing of any significant administrative service. If the patient care program in question loses \$1.5 million or more, the Trustee's approval to eliminate the program is not to be unreasonably withheld. However, they have the right to continue the project if they agree to fund losses that exceed \$1.5 million annually.
  - Disagreements regarding service eliminations, and other disagreements regarding the lease relationship, are subject to binding arbitration.
  - While not specified in the lease, BJC committed informally that BHC assets or revenues would not be pledged to any BJC HealthCare indebtedness.
  - Under the lease, CHAS/BJC has "exclusive control over the leased property so long as it is used principally for hospital and health care purposes." This includes the operation of the hospital, establishment and maintenance of policies and procedures, employment and termination of employees.
  - Under the lease, CHAS/BJC is to continue to provide medical care to indigent residents of the County consistent with the statutory and historical indigent care requirements of the hospital. CHAS/BJC is to maintain all required licenses, permits, and approvals; comply with all applicable laws; continue participating in Medicare and Medicaid programs; and not compete with BHC by developing or affiliating with entities that provide health care in the County or in several "Additional Counties" around Boone County.
  - The Trustees are not to develop health care facilities or programs that compete with BHC, and if they elect to sell real estate or equipment comprising all or any part of the leased property, CHAS/BJC has the "right of first refusal". If the Trustees receive an offer to purchase any of the leased property, then CHAS/BJC has the right to match the terms of that offer.
  - CHAS/BJC reports quarterly on several matters to the Trustees, including the financial condition or projected financial condition of BHC, capital expenditures, progress towards material elements of the hospital's strategic plan, and any material changes to operations, services, or facilities contemplated by senior management. The Trustees also

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receive audited financial statements and reports on the compliance with several benchmarks specified in the lease.

According to the Trustees, CHAS/BJC has remained in compliance with the terms of the current lease since its inception.

While not specified in the lease, bond documents provided by BJC indicate that BHC is not part of the BJC "Obligated Group" for debt financing purposes. Neither the Trustees' assets nor BHC assets have been pledged to repay BJC debt. The lease specifies that if BJC or CHAS file for bankruptcy, the Trustees can terminate the lease.

**Under the lease, during the calendar years 2001 through 2005, the Trustees have received an average of \$9.7 million annually in payments from the lease, excluding amounts that reimbursed them for principal and interest on bonds. The \$9.7 million annually represented 50 percent of the increase in BHC cash and cash equivalents in those years. In addition, the County has received an average of \$1.4 million annually.** Under the lease, the County and the Trustees together thus received approximately \$11 million annually during calendar years 2001 through 2005. The level of funding received by the Trustees has been highly dependent on the financial performance of BHC. If BHC's financial results had been less favorable, the Trustees would have received less funding through the lease.

**Under the lease, BJC has received \$5.2 million in annual reimbursement for specific corporate services that otherwise would likely have been incurred at BHC, \$6.2 million as a management fee (3 percent of net revenue), and \$9.7 million from the "cash split."** The total amounts have averaged \$21 million per year over the 2001 through 2005 time frame. BJC has advised that the corporate services provided to BHC are passed through to its owned hospitals at a rate nearly double that charged to BHC<sup>2</sup>.

The "cash split" amounts have been made after all other expenditure requirements have been met, including investing in the hospital's capital needs.

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<sup>2</sup> In other words, while BHC's net revenue is about 8 percent of total BJC net revenue, BHC is allocated about 4 percent of the cost of all allocated BJC corporate services.

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### III. FINDINGS

As described in the first section, to perform the assessment, The Lewin Group team asked two key questions regarding whether BHC *needs* to be leased, and whether current lease terms are fair to the Trustees and the County. This section presents our analyses of these questions.

#### A. Does Boone Hospital Center *need* to be leased?

We approached addressing the first question by examining the following issues:

- Are **market and financial risks** facing BHC high? If so, then leasing the hospital would moderate the financial exposure of the Trustees and the County to potential future challenges in operating the hospital.
- Does a lease structure provide the Trustees and the hospital with important **legal protections**? For example, if the Trustees become the operating Board for the hospital, would Missouri “sunshine laws” make it difficult for BHC to operate in an increasingly competitive environment?
- Does a lease structure provide the hospital with valuable **operational flexibility**? For example, if the Trustees become the operating Board for the hospital, would the hospital be subject to County personnel and purchasing requirements, and would that affect BHC’s ability to operate efficiently?
- Do the Trustees need the **services** that are provided by multi-hospital systems? If so, then leasing the hospital to a multi-hospital organization like BJC could remain a valuable option.
- Does leasing provide better BHC **oversight**? If a partner organization provides incremental and valuable insights that enhance governance, then a lease structure can provide value to the hospital.

##### 1. **Market and Financial Risks Facing BHC**

On many measures, BHC has performed very well in recent years. The hospital’s operating margin (excess of operating revenues over operating expenses, divided by operating revenues) averaged over 6 percent during the 2001 through 2005 time frame<sup>3</sup>.

The national average operating margin for not-for-profit hospitals has been about 2-3 percent for the last several years, and credit rating agencies such as Moody’s and Standard & Poors consider hospitals with a 3 percent margin and above on a consistent basis to be well above “investment grade.”

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<sup>3</sup> The 6 percent margin is particularly impressive because it is calculated after lease payments have been satisfied, including, for example the 3 percent management fee paid by BHC to BJC.

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A major variable in the hospital's favorable financial performance has been annual growth in admissions that has exceeded 4 percent. On an overall basis, the hospital's market share of inpatients improved through calendar year 2003. A second major variable is that the Medicare program has provided regular increases in reimbursement rates in recent years – a factor that is particularly important for BHC because over one-half of the hospital's patient care charges are generated by Medicare patients.

Based on the hospital's historical performance, the answer to the question: "Are **market and financial risks** facing BHC high?" would appear to be a clear "No". However, there are several market and reimbursement developments that make the answer less clear.

- **Population growth.** BHC receives slightly less than one-half of its inpatients from Boone County. The overall population of the County is anticipated to grow by 1.35 percent annually between 2005 and 2010. This annual rate is slightly lower than the 1.52 percent annual rate experienced during the 2000-2005 time frame. The number of persons aged 65 years and older is anticipated to grow 2.6 percent annually.

The populations of other area counties around Boone are projected to remain relatively constant over the next five years, with the "65+" population projected to grow 0.8 percent annually<sup>4</sup>. If the hospital does not lose market share, it should anticipate continued volume increases and a continued shift in patient mix towards Medicare patients.

- **University Hospital.** According to discussions we held with community representatives, University Hospital has implemented several initiatives to improve its operational performance and to add to its faculty ranks. A new research center, a focus on women's health and a Birth Center, and other initiatives should also be considered as variables that may affect BHC's future growth.
- **Physician Recruitment.** Analyses we reviewed for this assessment suggest that the Columbia region has certain physician needs in key specialties that if not met through recruitment initiatives may constrain the growth of BHC and other healthcare providers in the region.
- **Development of Freestanding Outpatient Centers.** Hospitals nationally are feeling the effects of free-standing outpatient diagnostic and treatment facilities. In some communities, for-profit specialty hospitals (in many cases developed in partnership with physicians) have affected the performance of general acute care facilities (like BHC). The Columbia community is not immune from these developments, and we understand that the number of freestanding outpatient centers is increasing (e.g., the Institute of Outpatient Surgery, a Gastroenterology Clinic, and ambulatory surgery centers).
- **Medicare Reimbursement.** On April 25, 2006, the Centers for Medicare & Medicaid Services ("CMS") published a proposed rule regarding Medicare reimbursement for inpatient hospital services. Under the proposed rule, some hospitals (principally smaller

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<sup>4</sup> Source: State of Missouri, Office of Administration.

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facilities in rural areas) would see above-average payment increases for Medicare patients. Other hospitals, particularly those with large numbers of cardiology and cardiac surgery, orthopedics, and other “high acuity” patients would see lower increases and possible payment reductions. BHC management, in consultation with BJC, analyzed the implications of the proposed rule and adjusted the hospital’s financial projection downward.

- **Cost of Supplies and Pharmaceuticals.** The BHC financial projection, which we reviewed for this assessment, also demonstrates the implications of continued inflation in the cost of supplies (e.g., stents, artificial knees, valves) and pharmaceuticals that are administered in the hospital setting.
- **New Bed Tower.** BJC, BHC management, and the Trustees have been analyzing the need for additional bed capacity at BHC. Analyses of future bed need in the community conclude that there appears to be a need for additional capacity at the hospital; however, those analyses are not yet complete. A new bed tower project would represent a sizable capital investment for the Trustees and the hospital, and likely would be financed through debt that would be issued by the Trustees and repaid from BHC’s operations. In the short run, this project would affect BHC’s financial performance but in the longer run should facilitate the hospital’s growth and cash flow, thus providing a financial return to the Trustees through the “cash split” formula.

Updated financial projections for the hospital incorporate the effects of the above factors. Those projections show that, on-average, BHC’s margins are likely to remain at above average levels for the next several years.

After considering the above factors, we conclude that market and financial risks are present for BHC; however, the hospital is positioned to perform well for the next several years. Many boards lease their hospitals to systems like BJC because the hospitals are experiencing financial distress or market weakness. It does not appear that the Trustees *need* to lease the hospital for these reasons.

## **2. Legal Protections**

The Sunshine Act was a major factor in the Trustees’ decision to lease Boone County Hospital to a not-for-profit corporation in 1988. The Act remains a consideration for the Trustees in considering whether or not BHC *needs* to be leased to BJC or another organization.

While the Missouri Sunshine Act provides a general exception for “confidential information” and recent court rulings have indicated that certain contracts and strategic planning documents could be protected as “trade secrets”, interpreting the Act is not clear cut. The Columbia market is increasingly competitive. Executive and physician compensation arrangements (not otherwise available on IRS form 990 filings), canceled checks, detailed budget and reimbursement information, contracts (e.g., for physician services), and other sensitive information that if made public could inform competitors as to BHC strategic plans and thus significantly affect the Trustees’ ability to operate BHC without a lease structure in place.

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### **3. Operational Flexibility**

Hospitals operated as not-for-profit corporations have certain advantages in terms of their ability to operate flexibly and respond rapidly to market and operational challenges. Trustee operation of BHC would re-instate civil service and government procurement rules on the hospital's operations and could invite the introduction of additional political perspectives into hospital policies and procedures. While public discourse and input into hospital operations is inherently valuable, transferring BHC operations back to the Trustees (such that the Trustees become the operating board for the hospital) would mean that the following would be subject to new public rules, terms, and conditions:

- Procurement and contracting
- Physician recruitment and partnerships
- Facility and strategic master planning
- Human resources

Transitioning BHC from a not-for-profit corporation to Trustee operation would entail several transition issues as well.

- Contracts with physicians, vendors, and managed care payers would need to be renegotiated, with uncertain outcomes
- Employees would need to transition from BJC to County/Trustee employment – positions would need to be classified within the County civil service system and healthcare and retirement benefits would transition to the plans that the Trustees would need to establish
- The strategic oversight not being provided by BJC would rest more squarely on the Trustees

The existing lease provides for a two-year period from the date that notice is provided by the Trustees to CHAS/BJC regarding early termination until termination is effective. The above issues would need to be addressed during that time frame so that the hospital's transition back to Trustee operation would not interrupt services.

In our assessment, leasing BHC increases the ability of the hospital to operate flexibly and respond rapidly to market developments.

### **4. BHC Need for Multi-Hospital System Services**

Under the leadership of the recently retired Chief Executive Officer, BHC has operated with more autonomy and independence from its multi-hospital system partner than other members of the BJC Healthcare system. Hospitals join multi-hospital systems (either through leases, acquisitions, or management contract relationships) for numerous reasons, including:

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- Improving market position and ability to negotiate effectively with managed care plans
  - Gaining purchasing power, and thus access to lower-cost supplies through group-purchasing arrangements
  - Obtaining better management because Chief Executives, Chief Financial Officers, and others have opportunities to advance within an overall healthcare system
  - Obtaining access to capital (such as debt financing) that otherwise would not be available or more expensive – because multi-hospital systems typically are viewed as more credit-worthy than free-standing facilities
  - Obtaining expertise in management, strategic planning, information systems, quality improvement, best practices, and operations improvement (among other insights) and the corporate discipline to apply them throughout the operations
  - The hospital is experiencing financial distress

We observe that few of these reasons recently have applied to BHC.

- The BJC HealthCare system has no other hospitals or facilities near enough to BHC to influence directly the hospital's ability to negotiate with managed care plans. BHC enjoys a level of market influence on its own by virtue of the services it offers, the growth the hospital has achieved, and its distinguishing characteristics with respect to other hospitals in the community. This would be true of any replacement lessee or management company.
- BHC can obtain access to favorable purchasing arrangements on its own, because the hospital is a large operation that purchases over \$50 million in supplies annually and it can participate in group purchasing contracts directly.
- The question of whether BHC can obtain "better management" as part of a multi-hospital system like BJC HealthCare is less clear. The recently retired Chief Executive Officer, who was well respected, was in place before the Trustees entered into the original lease with CHAS. The newly appointed CEO was an executive at another BJC HealthCare facility before agreeing to assume leadership of BHC. If BHC were operated as a free-standing, Trustee/County operated facility, the Trustees might be very successful in recruiting effective management to the facility or retain the services of a firm that provides management services under contract. The recruit's confidence in the stability of any management agreement or the consistency of Trustee oversight would be significant factors, as would his or her interest in relocating to Columbia to reside.
- BHC does not depend on its participation as part of the BJC HealthCare system to obtain access to debt financing. The hospital does not participate as part of the BJC "Obligated Group", and BHC's revenues and assets thus are not pledged to enhance the credit-worthiness of the BJC HealthCare system as a whole. In our view, BHC's financial performance has been sufficiently strong to ensure its access to debt capital either under

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a lease structure like the arrangement with BJC HealthCare or as a free-standing Trustee/County operated hospital.

- Over time, the BJC HealthCare system has provided increasingly valuable expertise to BHC; however BHC also has provided expertise helpful to other BJC HealthCare facilities. Among the array of corporate services provided by BJC to BHC, strategic and market planning, quality benchmarking, physician recruitment strategies, and new initiatives regarding operations improvement and streamlining have been most valuable to the hospital's performance.

On the overall question of whether BHC *needs* the services and capacities associated with a multi-hospital system to be successful, our overall conclusion is that access to these services is not a compelling reason for the Trustees to lease BHC. BHC has operated with a fair amount of autonomy over the years and could obtain financing, expertise, cost-effective purchasing arrangements, and reasonable contracts with payers on its own.

## **5. BHC Oversight**

The fifth aspect of whether the BHC *needs* to be leased is whether this type of arrangement facilitates oversight or governance of the hospital. In other words, would the Trustees' becoming the *operating Board* for BHC be as effective as the current structure through which the Trustees' have oversight of the responsibilities defined in the lease and BHC operations effectively are governed by policies established by a senior management team of a multi-hospital system (like BJC HealthCare) and the governing body of that multi-hospital system.

After conducting a series of interviews with Trustees, BHC managers, and BJC leadership, we observe that in several ways the BJC HealthCare System leadership serves as a governing body for BHC. The BJC System office has oversight of the BHC budget, helps establish operational policies and procedures, is involved in the hospital's overall strategic direction, and participates in major decisions regarding the hospital.

BJC HealthCare also is a well-respected health system with ties to a top medical school (Washington University).

While the Trustees may well be able to attract (or retain) an effective management team (or management company) for BHC, it may prove challenging for the publicly-elected Trustees to provide the depth of oversight that the current structure provides on a long term basis. The sophistication needed to manage a large health system that is Missouri-focused is not easily replicated.

**6. Summary of Assessment**

Based on the above assessment, we conclude that there are three principal reasons to consider continuing to lease BHC to another organization (Figure 4).

**Figure 4: Summary of Assessment Regarding the Need to Lease BHC**

	Yes	No
<i>Are market and financial risks facing BHC high?</i>		✓
<i>Will there be exposure to Sunshine laws?</i>	✓	
<i>Will there be substantial loss of operational flexibility?</i>	✓	
<i>Do Trustees need System services and supports?</i>		✓
<i>Does leasing provide better BHC Governance?</i>	✓	

While on a comparative basis, market and financial risks for BHC are relatively low and BHC does not appear to need the types of services and supports provided by a multi-hospital healthcare system, the Sunshine Act, operational flexibility, and governance/accountability issues suggest that leasing the hospital remains an effective option for the Trustees.

**B. Is the current lease fair to the Trustees and the County?**

The primary concerns expressed regarding the current lease between the Trustees/County and CHAS/BJC relate to the flow of funds from BHC to CHAS/BJC.

Under the current lease, CHAS/BJC receives three payments that result from services provided and operational margins achieved in operating BHC.

- An annual payment of \$5.2 million to reimburse BJC for providing various corporate services.
- A payment to BJC of 3 percent of BHC net revenues as full compensation for management services.
- Fifty percent of BHC’s net increase in cash and cash equivalents – a sum that averaged \$9.7 million annually during the 2001-2005 fiscal years. If the net change in cash and cash equivalents is insufficient to cover BHC’s operating expenses, capital expenditures, and lease payments, then BJC is responsible for fifty percent of the shortfall.

The above payments have averaged about \$21 million annually from 2001 through 2005.

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**In our view, focusing solely on the flow of funds between BHC and BJC provides an incomplete perspective regarding the equity of the arrangement.** The following questions are important to address in assessing the equity of the lease's financial terms:

- How does the lease between the Trustees/County and CHAS/BJC compare to other comparable leases in terms of the flow of funds between the parties?
- Are the Trustees and the County being compensated fairly for the use of their assets by CHAS/BJC?
- Is it likely that BHC will remain financially healthy throughout the lease period, such that at the end of the lease the Trustees will receive a viable and well capitalized hospital operation?

The next sections discuss these questions.

### **1. Characteristics of Other Leases**

As part of this assessment, The Lewin Group reviewed more than 10 other leases between public boards of trustees (hospital districts, cities, county Boards of Supervisors) and not-for-profit hospital boards and health systems. Key observations from that review include the following:

- The payments made by lessees to lessors range from nominal amounts of \$1 per year to amounts equal to debt service on bonds to fair-market value based amounts. Most are based on negotiations rather than an appraisal of land and buildings leased or on a valuation of the hospital operation in question. One provides that the lessee pay the lessor 2.25 percent of net revenue.
  - Leases with a nominal payment to the lessor generally are developed for hospitals that are experiencing significant financial distress.
  - Virtually all of the leases reviewed, except for those involving nominal amounts, determined the compensation arrangements based on negotiations and consideration of the financial performance of the hospital and the needs of the lessors, rather than a fair-market valuation.
- Most of the lease structures require that the lessee invest a certain amount of capital in the hospital. Alternatively, they require that lessee continue to operate the hospital so that its license is maintained, it continues to participate in the Medicare program, and it remains in compliance with all laws and regulations. These leases thus indirectly require the lessee to expend capital funds in the hospital to assure it remains operational for quality acute care services.
- In the other leases we reviewed, the lessee is able to keep *all* of the excess profits or cash flow after lease payments, operating expenses, capital, and other cash flow requirements at the hospital are met. While CHAS/BJC's compensation includes: reimbursement for corporate services, a three percent management fee, and a 50 percent "cash split" – in

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other leases the lessee can extract from the leased operations as much cash flow as it wants after specific requirements (such as the lease payment and required capital investment) are met.

- **When the other leases we reviewed terminate, the lessees generally are entitled to be compensated for their “leasehold improvements”** – the capital and other investments they have made during the lease period. This means that the lessors are left with a significant financial liability at the end of the lease. Lessors either must purchase various improvements from the lessees, or the lessees can remove equipment and the value of other financial assets they have created during the lease period.

This is very different from the current lease between the Trustees/County and CHAS/BJC, which specifies that at lease end, all BHC assets are transferred to the Trustees, except for the hospital’s cash balance which is split between the parties at termination. At termination, all of these assets (including medical records) will be transferred to the Trustees without any payment to CHAS/BJC.

In the “Discussion and Conclusions” section, we summarize our views regarding the principal strengths and weaknesses of the current lease in the context of the above points.

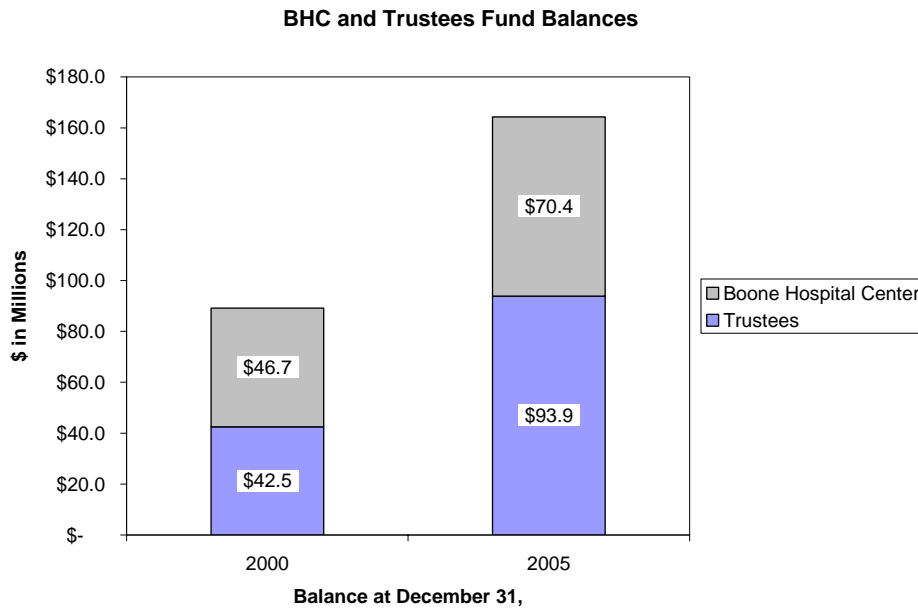
## **2. Trustee and County Cash Flows**

As previously mentioned, during the 2001 through 2005 time frame, the Trustees have received an average of \$9.7 million in payments from the lease. The \$9.7 million annually represented the Trustees’ 50 percent of the increase in BHC cash and cash equivalents in those years. In addition, the County received an average of \$1.4 million annually. **Under the lease, the County and the Trustees together thus received approximately \$11 million annually during calendar years 2001 through 2005.** The Trustees also have and will continue to receive a “minimum rental payment” equal to all debt service (principal and interest) on bond financings issued by the Trustees/County concerning the hospital.

**These payments have allowed the Trustees to develop substantive reserves and resources over the years. And during the current lease, the net worth or fund balance for BHC has increased by \$23.7 million.** These resources are important because in the event of lease termination, the Trustees’ resources, combined with those at BHC, would become the new “balance sheet” for BHC if the hospital were transferred back to Trustee management. The best way to portray the resources that have accumulated for the Trustees and at BHC is to compare “fund balance” that was present on the day before the new lease was effective (December 31, 2000) and the fund balance at the end of the most recently audited fiscal year, December 31, 2005.

Figure 5 portrays the change in net worth for the Trustees and for BHC during the current lease. These balances have continued to increase in calendar year 2006.

**Figure 5: BHC and Trustees Fund Balances At December 31, 2000 and December 31, 2005**



Both the Trustees and BHC have been able to increase their “net worth” or fund balances during the first five years of the current lease. The combined fund balances increased from about \$89 million at December 31, 2000 to over \$164 million at December 31, 2005 – or **approximately \$15 million annually**<sup>5</sup>. This has occurred because:

- The Trustees have received the “cash-split” resources and have retained or investment them for various board-designated purposes.
- The Trustees began fiscal year 2001 with about \$33 million in long term debt that financed BHC property and equipment and this debt has been repaid through the “minimal rental payments” coming from BHC to about \$31 million at December 31, 2005.
- The lease requires investment of 9 percent of BHC net revenue in BHC property and equipment. The value of property and equipment at BHC has grown by about \$19 million during the current lease term.

Figure 5 does not include the accumulated value of payments to Boone County, averaging about \$1.4 million annually.

Current projections suggest that annual payments to the Trustees (and thus also to CHAS/BJC) are likely to be lower during the next five years. The amount of annual funding from the cash-split may fall from the \$9-10 million average level to \$4-5 million. This results from anticipated

<sup>5</sup> In addition, effective on the signing of the current lease, a potential lease termination liability of approximately \$30 to \$40 million to pay for the value of personal property at BHC was resolved in the Trustees’ favor.

lower (but still above-average) margin performance for the hospital and the impact of debt service for the contemplated new tower. The payments to Boone County are scheduled to continue increasing based on the consumer price index.

Assuming continued favorable financial performance of the hospital and continued growth in resources for the Trustees and BHC, the Trustees would have a viable and well capitalized hospital at lease termination – which they will receive “free and clear”.

### 3. BJC HealthCare Cash Flow under the Lease

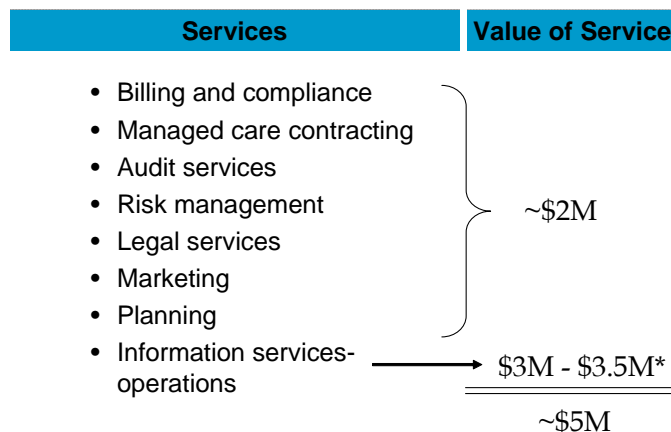
As previously mentioned, CHAS/BJC has received approximately \$21 million annually from the BHC lease during the 2001-2005 time frame. An annual \$9.7 million of this amount is from the cash-split. About \$6.2 million annually has been in the form of a management fee (3 percent of net revenue). BJC also has received \$5.2 million in annual reimbursement for specific corporate services.

Because BHC has performed well financially, BJC HealthCare also appears to have done well under the lease. However, we believe it important to recognize that in most lease arrangements, the lessee typically can allocate itself *all* of the earnings from the leased operation (after all lease payments and required capital spending) and also is entitled to be reimbursed for the value of leasehold improvements at lease end. On this basis, the amount of funding paid to BJC by BHC appears quite reasonable.

The Trustees asked The Lewin Group specifically to consider the reasonableness of the compensation paid to BJC HealthCare, in particular the value of the services received by BHC in return for compensation provided. These concerns are valid, in part because the “3 percent management fee” and the \$5.2 million in annual reimbursement for corporate services directly affect the funds the Trustees receive (they reduce the amount of funding available for the cash-split) and because if the compensation paid to CHAS/BJC is too high, BHC could be weakened financially and be less viable at the end of the lease.

Figure 6 displays an assessment of the corporate services provided by BJC to BHC.

**Figure 6: BJC Corporate Services**



\*Based on industry benchmarks

Of the \$5 million in corporate services, based on industry benchmarks we estimate that about \$3.0 to \$3.5 million is associated with information systems operations and personnel – the majority of which are physically located at BHC. These personnel would need to be retained or replaced at lease termination. This implies that BHC is reimbursing BJC about \$2 million annually for all other corporate services – an amount well below the amounts assessed other comparable hospitals within the BJC system for the cost of these services.

As a result, of the \$21 million paid annually to CHAS/BJC from BHC operations, about \$5.2 million appears to be compensating BJC for its costs associated with BHC and the remainder provides a return to the System. Thus, under the current lease:

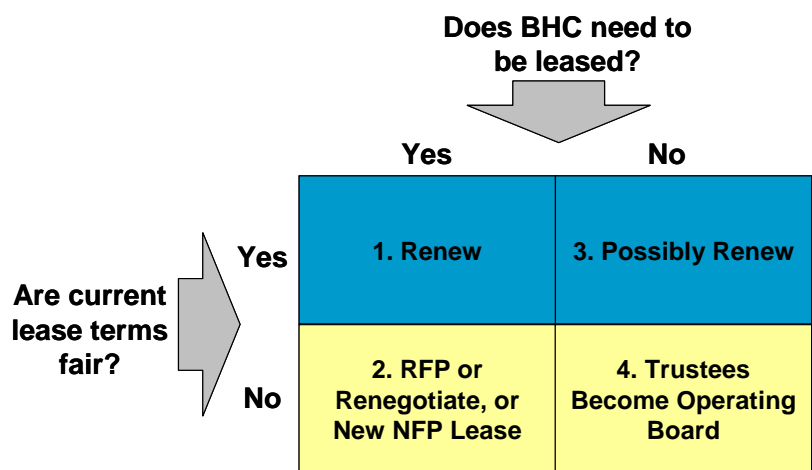
- **The Trustees and the County have been receiving a total value of about \$15.8 million annually** (\$9.7 million from cash split to the Trustees, \$1.4 million in payment to the County, and \$4.7 million annual increase in the net worth of BHC).
- **BJC also has been receiving a total value of about \$15.9 million annually** (\$9.7 million from the cash split and \$6.2 million for the management fee). This amount excludes the \$5.2 million in annual compensation that reimburses BJC for the cost of corporate services (including information systems).

The two parties have been receiving roughly equivalent amounts under the current lease structure.

#### IV. DISCUSSION AND CONCLUSIONS

The framework for this study focused on two key questions: (1) Does BHC need to be leased? and (2) Are current lease terms fair?

Figure 7: Project Framework



The foregoing analysis indicates that several of the original reasons for the Trustees entering into a lease in 1988 remain valid, principally the Sunshine Act and the operational flexibility

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that leasing the hospital provides. The relationship with BJC HealthCare highlights how a multi-hospital system also can provide value through: reviewing budgets, helping establish operational policies and procedures, involvement in overall strategic direction, providing quality and operational benchmarking resources, and in other ways.

The principal advantage of having the Trustees become the operating board for the hospital by exercising the early termination rights are that BHC could retain *all* of its cash flows and these resources could be invested entirely in the Boone County region.

- Under this option, the Trustees could hire their own CEO or a management company. Instead of giving up 50 percent of the hospital's cash flow and paying a \$6.2 million management fee, based on our research the Trustees could retain the services of a management company for \$2-3 million annually (depending on the services the Trustees request from the management company).
- However, the hospital would lose the above lease structure benefits and would experience a significant transition for employees, contractors, and other stakeholders.

As leases are concerned, the current lease between CHAS/BJC and the Trustees appears to have reasonable terms. The lease has been carefully and thoughtfully amended and constructed. The Trustees will receive the hospital at lease end "free and clear". During the term of the lease, the Trustees and BHC have been able significantly to increase net worth. In large part these terms have been effective because the hospital has performed well.

One possible course of action for the Trustees is to issue a Request for Proposals designed to yield even better terms from BJC or an alternative lessor. That course of action (a "market test") presents risks. There are no guarantees that better lease terms could be realized through this process. BJC has advised that it will not participate. Accordingly, this has the risk of losing the current arrangement before a replacement option could be analyzed.

The following appear to be the principal advantages and disadvantages of the current lease.

#### **A. Advantages of the Current Lease**

- Continuing the current lease at least until 2010 would allow the Trustees to continue the current relationship with a health system with a good reputation and a track record of performance at BHC.
- CHAS/BJC has complied with all lease requirements to date and BHC has an excellent record on many quality metrics while under BJC's day to day operating control.
- Leasing BHC provides three principal advantages to the Trustees/County: ability to protect information from public disclosure that could damage BHC strategically, ability to operate BHC with more flexibility than would be available if the hospital were Trustee/County run, and access to expertise and resources and oversight from a multi-hospital system with a major financial interest and nearly a 25 year experience in addressing Boone County Hospital's needs.

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- Several of the concerns expressed by the community in 1988 regarding the lease: the potential for a loss of high quality care, possible insufficient capital investment in the hospital, and a growth of patient referrals to St. Louis have not occurred.
  - In most lease arrangements, the lessee typically can allocate itself *all* of the earnings from the leased operation (after all lease payments and required capital spending) and also is entitled to be reimbursed for the value of leasehold improvements at lease end. The current lease *caps* amount of funding that CHAS/BJC can earn from the BHC operations.
  - The 9 percent capital requirement assures an ongoing investment in BHC buildings and equipment.
  - In this lease structure, BJC and the Trustees have strong, shared incentives to assure BHC is successful.
  - During the lease, BHC has grown significantly. Quality measures published on the BHC web site show that quality of care at the hospital is high. The hospital's net worth has increased over the last five years.
  - At the end of the lease, all BHC assets will be the property of the Trustees without the need to compensate CHAS/BJC at lease end for leasehold improvements. This is a real advantage compared to other leases that require the lessor to compensate the lessee for leasehold improvements (or that allow the lessee to remove equipment and other property they have purchased during the lease).
  - The Trustees have more input into BHC than is the case for many hospital lessors. The Trustees retain certain rights over services at BHC and have significant input into capital investment decisions at the hospital. Under the lease, the Trustees also have representation on the BJC HealthCare Governing Board.
  - The lease specifies indigent care requirements for BHC.
  - Continuing with the current lease avoids certain risks associated with "opening up the lease" to substantial renegotiation or the uncertain results of Request for Proposals process.
  - Continuing with the current lease also avoids challenges that are associated with a significant transition for the hospital's operations.
  - BJC has indicated that in the event the Trustees decide to continue the lease, BHC will be able to request additional funding from BJC's community benefit funds.
  - BJC shares 50 percent of any cash shortfall that materializes at BHC.
  - The historical and projected performance of BHC provides the Trustees with a fair return on the assets being leased to BJC and more than generally is received under the county hospital leases we have reviewed.

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In connection with the renewal, BJC has agreed to exercise its option to renew such that the lease will have a ten-year term. This will enable the construction of the new tower.

## **B. Disadvantages of the Current Lease**

- If the Trustees were the operating Board for BHC, the Trustees and BHC would benefit from the full amount of the cash flow that BHC would generate under that circumstance, and would not need to share these funds with another organization like BJC. However, the Trustees also would lose the benefits described in this report that are associated with a lease structure.
- Stakeholders perceived that BHC's operations are providing substantial resources BJC HealthCare.
- Under the lease, the Trustees bear financial risk for the performance of the hospital if it generates cash flow deficits, and cash-split payments to the Trustees are not guaranteed because they depend on the hospital's performance. The Trustees appear to have been willing to accept this risk because the current lease is relatively short (10 years), has the early termination provision, and because at the time the lease was amended the hospital had a track record of favorable financial performance.
- If the Trustees invest resources in BHC, their cash flow return is reduced by one-half. For example, if the Trustees decide to invest in a new building, their return is provided through the cash-split mechanism and they share in 50 percent of any incremental cash flow generated<sup>6</sup>.

However, the full amount of the investment is returned to the Trustees at the end of the lease. If the Trustees use debt financing for projects at BHC, the debt service is fully reimbursed through BHC operations.

- BHC has not received as much value from participation in the BJC Health System as do other hospitals that are part of multi-hospital systems. The hospital historically has operated quite independently under the leadership of the Chief Executive Officer who recently retired.
- In today's climate that is focusing on the charity care and other community benefits provided by tax-exempt healthcare organizations, the lease could be stronger in its dedication of resources to community needs based on needs assessments.

## **C. Conclusion**

There is no question that since the Lease was amended BHC has performed well both financially and clinically. If the early out option were simply viewed as a mid term safety option to enable the Trustees to terminate BJC based upon poor operating performance, the past

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<sup>6</sup> In a letter from BJC to the Trustees dated May 12, 2006, BJC has acknowledged that with respect to any property invested by the Trustees, the Trustees will receive a market rate of return going forward.

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performance of BJC and its commitments going forward would not justify termination. Although the Lease is short on operating specifics, BJC's management and the local administrators, physicians, and staff have collaborated to bring an excellent hospital to Boone County. The returns to both the Trustees and BJC have been large and the Trustees should be able at the expiration of the Lease to negotiate a renewal on favorable terms or to exercise other options.

Moreover, BJC has provided a strategic and facilities plan that will, if implemented, involve substantial renovations that will continue to improve the breadth and capacity of services. If instead, the early termination were viewed as an option to address concerns going forward, we have identified certain disadvantages that could be addressed either from a successful renegotiation or following an RFP process. This approach is by no means certain and would only be preferable to the current arrangement if the RFP or any renegotiation were successful in providing a structure that was equivalent on quality and improved on economics, the transition was successful and if the performance of the selected management company was equal to or better than that of BJC.

Given BHC's strong finances and excellent medical staff there will likely be a management company or health system of good experience and reputation that would welcome the opportunity to lease or manage BHC with lower management fees or profit splits than those being paid to BJC. Only after selection and any transition challenges, would the advantages and disadvantages be known. Choosing this option will likely result in the loss of BJC as a participant.

There are strong community and business considerations that would support either decision.