The Regents of the University of California

COMMITTEE ON HEALTH SERVICES
September 19, 2007

The Committee on Health Services met on the above date at Mondavi Center, Davis campus.

Members present: Regents Allen, Blum, De La Peña, Dynes, Island, Johnson, Lansing, Parsky, and Pattiz; Advisory members Shewmake and Croughan

In attendance: Regents Brewer, Bugay, Gould, Hopkinson, Kozberg, Lozano, Marcus, Moores, Núñez, Preuss, Ruiz, Schilling, Varner, and Wachter, Regents-designate Cole and Scorza, Faculty Representative Brown, Secretary and Chief of Staff Griffiths, Associate Secretary Shaw, General Counsel Robinson, Chief Investment Officer Berggren, Provost Hume, Executive Vice Presidents Darling and Lapp, Vice Presidents Foley and Sakaki, Chancellors Bishop, Block, Drake, Fox, Kang, Vanderhoef, and Yang, Acting Chancellors Blumenthal and Grey, Recording Secretary Smith

The meeting convened at 12:20 p.m. with Committee Chair Lansing presiding.

1. **APPROVAL OF MINUTES OF PREVIOUS MEETING**

Upon motion duly made and seconded, the minutes of the meeting of January 18, 2006 were approved.

2. **UCSD MEDICAL CENTER PARTICIPATION IN AMBULATORY SURGERY CENTER JOINT VENTURE, SAN DIEGO CAMPUS**

The President recommended approval of UCSD Medical Center's participation in an ambulatory surgery center joint venture with Surgical Care Affiliates.

The Need for Ambulatory Surgery Capacity Near the East Campus

Chancellor Fox made the presentation on behalf of UCSD. In keeping with industry trends, ambulatory surgery cases at UCSD Medical Center have grown dramatically, increasing 11 percent since just last year and 23 percent in the last three years. The growth has been fueled by surgical faculty recruitments resulting in increased surgical activity, population growth in the region leading to increased demand, and the rise in minimally invasive techniques that do not require overnight hospitalization of the patient. UCSD Medical Center-Hillcrest has an

Outpatient Surgery Center. UCSD Medical Center-East Campus has no dedicated ambulatory surgery space.

There is a pressing need for additional ambulatory surgery capacity. UCSD expects the advances in minimally invasive surgery to continue and foresees the potential for expansive growth in the ambulatory surgery arena. The need is greatest at the UCSD Medical Center-East Campus. The seven inpatient operating rooms located in the Thornton Hospital on the East Campus must accommodate a wide range of cases, from complex inpatient procedures (e.g., pulmonary thromboendarterectomies, complex spine surgeries, intraperitoneal hyperthermic perfusion) to ambulatory surgeries (foot surgery, hand surgery, breast biopsies). This creates inherent inefficiencies in scheduling and managing cases, with unforeseen emergencies or extended inpatient surgeries taking priority and necessitating delays or rescheduling of scheduled ambulatory procedures.

In addition, the Medical Center-East Campus combined recovery space, which serves both the operating rooms and the special procedure areas, is at capacity. The East Campus is a major focus of development for the Medical Center, yet with the operating rooms already operating at capacity and patient recovery capacity limited, current demand is not being met and growth potential is severely hampered.

The Departments of Surgery and Orthopaedic Surgery have also identified the need for a market-driven ambulatory surgery center (ASC) in La Jolla as a key element to the retention and recruitment of surgical faculty and future business development. Currently, some UCSD faculty must practice in unaffiliated surgery centers in La Jolla for capacity and patient convenience. Expanding UCSD's ambulatory surgery capacity in La Jolla would provide a means for growth for the departments while accommodating UCSD cases currently being performed in unaffiliated centers. In addition, the departments plan for the additional recruitment of 15 to 20 new faculty over the next five years. Additional surgical capacity must be created to provide room for the recruits and to retain and expand the practice of the current faculty.

In order to meet current patient demand for ambulatory surgery services, expand and develop these services to serve a growing population, and create needed inpatient operating room capacity on the East Campus for patients whose needs are more complex and who require hospitalization, UCSD has been exploring options for establishing a dedicated ASC near the East Campus.

Options Considered

Through a multi-disciplinary review that included physicians, nurses, and planners, several options for adding ambulatory surgery capacity near the East Campus were examined. For the long term, constructing an ASC/Medical Office Building (MOB) on the East Campus was identified as the desired option.

However, due to high capital costs and fundraising constraints, the timeline for completion of an ASC/MOB would be at least five to seven years and would compete with capital and fundraising priorities for the proposed East Campus inpatient tower that is currently being planned.

Establishing a dedicated ASC near the East Campus has been identified as the most cost-effective short term solution. This solution requires that the campus seek to open a new practice in leased space or partner with an existing ASC.

Opening a new ASC practice in leased space would require at least $2 million to $2.5 million in tenant improvements and another $2.5 million to $3 million in capital investment. Furthermore, appropriate space for a new ASC practice is not currently available near the East Campus. A new center would take at least 15 to 18 months to develop, which would further delay growth potential and the receipt of new revenue.

Partnering with an existing ASC is more quickly achievable and cost effective. The campus has identified a potential partner, UTC SurgiCenter, located less than two miles from the East Campus. The facility is owned and operated by Surgical Care Affiliates (SCA). Over the last two years, the main surgical group that used the center dissolved and the individual surgeons left for other ASCs. This has left the center with around 1,000 cases annually, less than one-third of its capacity.

Description of Partner

SCA, a recent spin-off the HealthSouth Corporation, currently owns a network of 139 outpatient surgery centers and three surgical hospitals, making it one of the largest owners and operators of ambulatory surgery centers in the country. SCA was formed in early 2007 and is owned primarily by Texas Pacific Group (TPG), an investment partnership centered in Fort Wayne, Texas. The new company has approximately 6,000 employees and retains much of the management structure from the HealthSouth surgical division. In California, SCA operates and manages 33 ASCs. SCA is involved in a number of joint ventures including projects with Vanderbilt University Medical Center in Tennessee and the Sutter health system in Northern California. The SCA business was valued at $920 million upon acquisition by TPG and has annual revenues in excess of $900 million.

Proposed Joint Venture

Given UCSD's immediate need for expanded ambulatory surgery facilities and SCA's desire to revitalize the UTC SurgiCenter, the formation of a joint venture to operate the ASC is proposed. The joint venture would be owned 80 percent by The Regents and 20 percent by SCA and would operate all functions of the ASC. The structure would be a Delaware Limited Liability Company (LLC) that would be governed by a five-person management body made up of three representatives from UCSD and two from SCA. The structure will be based on an Operating

Agreement that sets the rules of operation and management including certain key business decisions requiring consent of four of the five members of the management body. These decisions requiring a super-majority include:

- Sale, exchange, or encumbrance of Company's assets
- Incurrence of debt by the Company in excess of $1 million
- Issuance of additional equity securities or other interests in the Company
- Dissolution of the Company [within the first seven years of operation]
- Amendment of this Agreement or the Certificate of Formation
- Settlement or compromise of any litigation, controversy or claim involving the Company
- Entry by the Company into any agreement with a potential referral source
- A call for additional capital contributions from the Members

Profits or losses will be shared by the owners of the joint venture based on their ownership percentage (initially 80 percent to 20 percent). The joint venture will be operated in a manner that is consistent with UCSD's non-profit mission and will not jeopardize UCSD's tax-exempt status. Future capital needs outside of routine operation will be based on ownership percentages. The ASC will be responsible for credentialing and medical practice, and will be open to both UCSD and community physicians.

Ambulatory Surgery Center Operations

The ASC will be a stand-alone business operating in leased facilities, with its own management, staffing, billing, collections, and all other functions. Pursuant to a management agreement, SCA will provide the day to day management of the ASC. SCA will be responsible for providing management, administering and purchasing services, and all other management support for operation of the ASC, subject to certain limitations. Responsibilities include but are not limited to:

- Maintaining the accreditation of the ASC with appropriate agencies
- Employing, supervising, directing. and discharging staff on behalf of the LLC
- Establishing staffing schedules
- Creating wage structures
- Implementing personnel policies

SCA will be paid a management fee of 6 percent of gross revenues after deduction for contractual allowances. The fee is within the benchmark for ASC management contracts in San Diego. The initial term of the management agreement is five years followed by a two-year term to match the lease timeframes. Renewal of the contact will be based on mutual agreement of the owners of the joint venture and SCA as the management company.

Capital Price

Based on a third party valuation of the ASC, the UTC SurgiCenter is valued, based on the cost approach, at $662,000 net of existing debt. For purchasing 80 percent of the venture, the price would be $529,600. In addition, the cost to purchase new equipment for the ASC is estimated to be $625,000. The 80 percent share of the capital for equipment is $500,000 to bring the total cost for participating in the joint venture to $1,029,600.

The valuation is performed by VMG Health, a well known health care valuation consultant. In its report, VMG states that it relied on the cost approach to arrive at the valuation which, in its opinion, is appropriate. UCSD has critically reviewed the report and believes the valuation is fair.

In addition to the purchase price and costs to capitalize the ASC, the joint venture will also require working capital for operations during the period that will be required to obtain the facility license from the State and approval by Medicare. SCA projects the ASC will require working capital of approximately $2.2 million of which UCSD will be responsible for 80 percent. The amount is only an estimate and the actual amount will depend on operations and the total time required to obtain the appropriate regulatory approvals and begin billing and collecting from payers. For modeling purposes, UCSD has estimated that one-half of the working capital funds will be returned to the owners once State licensure and Medicare approval have been received and bills have been submitted and collected.

Off-Campus Subleased Space

The UTC SurgiCenter is located at 8929 University Center Lane, La Jolla, California, where SCA currently subleases and occupies approximately 12,000 square feet, consisting of four separate spaces, with two sub-landlords, who are non-affiliated physicians. The subleased space includes three surgery rooms, six recovery beds, other clinical space, a business office, storage space, and an equipment area. Once the joint venture has received licensing approval from Centers for Medicare & Medicaid Services (CMS) and California Department of Health Care Services (DHCS), SCA will cause rights under the subleases to be transferred to the LLC, which will assume responsibility for the remaining term of the four sublease agreements, which expire on November 30, 2014. The first year's maximum base rent for all four subleases totals $545,153. The maximum base rent for the seven year term is $4,700,718. The sublease obligations are currently guaranteed by HealthSouth Corporation, and, although the LLC will take responsibility for payment of the rent, the parties anticipate that this guarantee will continue until the end of the term of the subleases. HealthSouth has requested that UC and SCA provide reasonable assurances that HealthSouth will not be required to fulfill the guarantee. UCSD believes that, in the unlikely event that such assurances are required, that UCSD has reasonable alternative uses for the space. The space shall be modified to be in conformance with all Regents' requirements for leased space.

Patient Volume

The ASC will be a multi-specialty practice offering Orthopaedics, General Surgery, Otolaryngology, Urology, Plastic, and Gynecological Surgery. Based on a model including planned surgical faculty recruitments, efficiency gains and population growth, UCSD expects to perform over 7,100 surgeries in an ambulatory setting in the fiscal year ending June 2009. Of the cases, 33 percent would be performed at the new ASC while the remainder would be scheduled at existing sites including the Outpatient Surgery Center in Hillcrest. The 2,300 UCSD cases at the new ASC will combine with the 1,000 existing community cases at the ASC bringing the total volume to 3,200 cases in the first year. UCSD estimates that by the fourth year of the joint venture, the volume at the ASC will increase to 3,800 cases, of which 3,200 will be from UCSD physicians.

Financial Performance

As a result of the new ASC, UCSD will benefit financially from the increased surgical capacity made available at its existing sites as well as its share of the net income generated from the UTC SurgiCenter. The ASC will provide immediate financial benefit to UCSD because the cost per case will be significantly less than similar cases performed at UCSD due to the focus and structure of the ASC.

In the fiscal year beginning July 2008, UCSD expects the new ASC to generate approximately $8.8 million of net revenues and a net margin of $3.5 million of which UCSD's share would be $2.8 million. This is approximately $700,000 more margin to UCSD than is projected to be generated from ambulatory surgery without the new capacity provided by the ASC. By the fourth year, UCSD estimates the increase in its margin from ambulatory surgery cases would be approximately $900,000 annually.

The payoff period for the investment would be 2.5 years assuming a total capital outlay of $1.87 million provided that 50 percent of the working capital is collected and returned to the owners.

Staffing

No UCSD staff positions will be lost because of the ASC. All ASC staff will be employees of SCA, in its role as manager of the ASC, and will be under the management and control of SCA. The salary and benefits of the employees will be based on SCA compensation rates. The ASC will reimburse SCA for employment expenses actually incurred at the ASC. UCSD will have no direct involvement with the selection, hiring, or managing of SCA personnel.

Timeframe

UCSD has an immediate need for surgery capacity at the UCSD Medical Center-East Campus. Projections indicate that additional surgery capacity will still be needed even with the opening of the new Sulpizio Family Cardiovascular Center in FY 2011, which will add four inpatient operating rooms to the hospital facility.

The ASC, which should be viable for at least the seven years of the leases, will provide a bridge allowing for development of a more permanent solution to the need for additional inpatient and outpatient operating room capacity, including the potential for building an on-campus ASC. The joint venture includes a provision for a planning review after five years with both parties reviewing the status of the ASC and the potential for continued collaboration after the end of the initial lease terms. All documents will contain sufficient wrap-up clauses to allow for unconditional termination of the joint venture after twelve years.

Discussion of Risks

State Licensure and Approval by Medicare

In order to bill and collect for its services, the joint venture will need to obtain a new license from DHCS and receive approval from CMS for its Medicare cases. The ASC will be operated with a minimum number of cases while awaiting these approvals, which could take as long as six months. If the joint venture is unable to obtain approvals in nine months (which UCSD and SCA believe is unlikely, since the ASC is currently approved by CDHS and Medicare), UCSD and SCA have agreed that the joint venture will cease business and the joint venture will be terminated.

Equipment and Facilities Upgrades

The estimate of $625,000 for equipment and facilities upgrades is based on a preliminary review of the UTC SurgiCenter and provided by SCA. UCSD will continue to review the capital estimates for needed new equipment, upgrades, and facility modifications prior to start-up of UCSD operations at the ASC. If UCSD identifies needs for initial operations that are greater than $625,000, UCSD will be required to fund 80 percent of the additional expense.

Community Physician Patient Volume

The financial model assumes that the community physician surgical cases that are currently performed at the UTC SurgiCenter will remain at least for the first few years as UCSD increases its outpatient surgery volumes. The community cases are performed by a handful of physicians who do not have a financial stake in the UTC SurgiCenter. There is risk that the physicians will move their cases to another ambulatory surgery center where they could purchase an interest.

Because these physicians have practiced at the UTC SurgiCenter without a financial share up to this point, it is believed the ASC will be able to retain their cases by continuing to accommodate their practice patterns and providing excellent service to them and their patients. Even without these cases, the ASC will still be profitable; however, the payoff period would be extended.

Summary

The need for surgical capacity, especially at the East Campus, is a challenge for UCSD Medical Center. The opportunity presented by the SCA joint venture would provide needed capacity immediately to relieve the East Campus operating rooms and recovery areas, while offering an excellent growth opportunity for the Departments of Surgery and Orthopaedic Surgery. The cost of creating the Joint Venture is significantly less than the expense of opening a new ASC and the location and opportunity to establish the practice in a short timeframe will support continuity of the current practice with the potential for immediate growth. The profitability of the venture is strong and would provide additional sources of revenue to the campus.

In response to a question from Regent Johnson regarding liability, CEO Liekweg explained that the proposal involves the creation of an LLC, of which the University will have an 80 percent share. The University will hold three out of five board seats, and thus will have very direct involvement based on the performance metrics set for the operation. Most actions that relate to the governance of the venture will be a simple majority, allowing the University to retain control over such actions. Mr. Liekweg noted that the venture into which the University is entering is an ongoing, accredited venture with a good track record. The majority of cases will be performed by UCSD faculty.

Faculty Representative Croughan pointed out that the University has rarely fared well when either University staff or faculty are off-site. Malpractice suits and medical errors more often than not occur at off-site locales where the University does not have a strong base; it has been difficult for the University to reduce medical errors under those circumstances. She recognized that there will be Board oversight, but staff are to be employed by a company only in existence for one year. She expressed her hope that elements be incorporated into operating agreements to ensure University oversight regarding medical error, staff oversight, nursing compliance, and so forth.

Mr. Liekweg gave his assurances that these issues can be incorporated into operating agreements. He noted that the medical staff executive committee, which provides oversight to staff and sets quality standards, will be comprised of a majority of UCSD faculty, thus mitigating a number of the issues experienced in differently structured ventures.

Regent Island spoke of the need for assurances that patients will receive UC quality care. Mr. Liekweg explained that the venture will be driven in large measure by UCSD surgeons. That, coupled with the fact that the board will be comprised of UC majority seats, will enable the development of criteria consistent with the UCSD mission in terms of patient care, research, and teaching.

Regent De La Peña inquired as to why UCSD did not develop the center internally, and whether or not there was a buy-out option. Mr. Liekweg explained that this option is the fastest way for the UCSD Medical Center to create capacity for an already stressed facility. In terms of a buy-out, the proposal is for a 12-year LLC that will incorporate out-clauses as the operating agreement is negotiated. Certain out-clauses would be triggered by simple majority. Mr. Liekweg stressed that a significant amount of time was spent evaluating the merits of the deal, and that counsel will be consulted to determine an exit strategy.

Upon motion duly made and seconded, the Committee approved the President's recommendation and voted to present it to the Board, Chairman Blum recusing himself from voting in order to avoid the appearance of a conflict of interest.

The meeting adjourned at 12:30 p.m.

Attest:

Secretary and Chief of Staff