



Paladin Healthcare Capital, LLC

PRIVILEGED AND CONFIDENTIAL

September 12, 2014

Andrew Turnbull
Houlihan Lokey
123 North Wacker Dr.
4th Floor
Chicago, IL 60606

Re: Acquisition of Daughters of Charity Health System

Gentlemen:

Paladin Healthcare Capital, LLC (“Paladin,” or the “Buyer”) is pleased to submit this updated non-binding proposal (the “Proposal”) to acquire substantially all of the assets (the “Business”) of Daughters of Charity Health System (“DCHS” or the “Seller”) all as more fully described in the February, 2014 Confidential Offering Memorandum (the “CIM”) and the online data room posted on Smartroom. For purposes herein, the acquisition by Buyer of the aforementioned Business of DCHS is hereafter referred to as the “Transaction.” This letter supersedes and replaces our letter dated as of May 21, 2014 in its entirety.

We greatly appreciate the efforts and resources that DCHS has committed to discussions and negotiations regarding our Proposal and are confident that the revised Proposal outlined in this letter will provide both parties with significant confidence in a Transaction that can be consummated on an expedited basis.

As we have traded several drafts of the definitive asset purchase agreement (the “Definitive Agreement”) reflecting the Transaction with your counsel, and have done significant work since our last all-hands call, we believe we can expeditiously revise and finalize the Definitive Agreement with your counsel in the event the parties agree to move forward on the terms described below.

The Revised Proposed Transaction Structure

Based on the information we have received to date, Buyer is prepared to acquire the Business for a fixed aggregate purchase price of \$384mm (the “Purchase Price”) based on the projected cash requirements of DCHS at the closing of the Transaction (the “Closing”) as reflected on the pro forma cash flow statement and June 30, 2014 balance sheet, both of which were recently delivered by DCHS to Buyer and which would be attached as exhibits to the Definitive Agreement. Based on these documents and a theoretical April 1, 2015 closing date (the “Closing”), such Purchase Price would enable DCHS to retire its outstanding bond obligations and pay all expenses incurred in connection with the Transaction. \$284mm of the Purchase Price would be paid by Op-Co Parent and Prop-Co Parent (each described below and together, the “Buyer Entities”) in cash and \$100 million of the Purchase Price would be payable by Op-Co Parent pursuant to a secured promissory note (the “Purchase Price Note”) junior in priority to Op-Co Parent’s A/R revolving line of credit which would be due and payable in installments such that it is repaid in full prior to the end of the

current round of QAF expiring in 2016 (“Current QAF Payments”). The Purchase Price Note will be secured by, and paid out of, 35% of Current QAF Payments as they are received by Op-Co Parent and will bear interest at an annual rate customary for subordinated notes in similar transactions. In this regard, at no time will the outstanding balance of the Purchase Price Note be in excess of 35% of the outstanding QAF receivable.

Additionally, Buyer would assume outstanding pension liabilities of DCHS which Buyer understands to be approximately \$283 million along with certain other specified liabilities that the Buyer deems necessary for future operations (e.g., equipment leases). The Purchase Price would be subject to a post-closing adjustment based on the difference between estimated asset values and actual asset values (as determined through a valuation process to be set forth in the Definitive Agreements).

Buyer will not be assuming Accounts Payable (“A/P”), but will be providing two contingent promissory notes that provide a tangible opportunity for the A/P to be fully paid over time. To that end, the Op-Co Parent (described below and together with the Prop-Co Parent, the “Buyer Entities”) would issue to DCHS two additional contingent promissory notes as follows: (i) one contingent promissory note (the “Indemnity Note”) would be issued in the amount of \$30 million which would be due and payable in full on the 24-month anniversary of the Closing and which would be subject to offset to fulfill DCHS’s indemnity obligations under the Definitive Agreement; and (ii) a second contingent promissory note (the “QAF Note”) would be issued in the amount of \$60 million which would be due and payable in installments equal to no less than twenty five percent (25%) of any future QAF payments for 2017 and beyond (excluding than those associated with the current round of Current QAF which covers 2014 through 2016 Payments) received by the Buyer Entities Op-Co Parent following the Closing (“Future QAF Payments”) until such time as the QAF Note was repaid in full.

For the avoidance of doubt, if subsequent rounds of QAF payments are not approved and no future QAF payments were received by the Buyer Entities Op-Co Parent, no amounts would be payable under the QAF Note. That said, the current consensus is that such future rounds of QAF are highly likely, and therefore the two notes in combination or the QAF Note on a standalone basis represent tangible opportunities for A/P to be paid in full over time. Each note contemplated hereby will carry an interest rate of 5% per annum.

To effect the Transaction, Paladin has or will establish a series of special purpose entities (“SPEs”), including:

- (a) **Op-Co Group.** Op-Co Parent, a California S-corporation (“Op-Co Parent”), which will assume all pension obligations of DCHS (funding deficits for which we understand to be approximately \$283mm) and form several subsidiary operating companies (each, an “Op-Co”) that will serve as the operating companies of the Business. It is currently contemplated that Op-Co Parent will arrange for a surety bond to be posted in an amount required to continue DCHS’s multi-employer pension plan following closing to the extent necessary to consummate the Transaction.

Op-Co Parent will acquire from each of DCHS’s six acute care hospitals (the “Hospitals”), the operating assets (e.g., accounts receivable, all rights to any QAF payments and other government receivables, inventory) and intangible assets (e.g.,

licenses) of each such Hospital free and clear of all liens and would contribute such assets to Op-Cos immediately following the Closing. Op-Co Parent will assume all other contracts (other than contracts that cannot be assigned at Closing) and transferrable permits relating to the Hospitals (including third party payor contracts, collective bargaining agreements, Medicare and MediCal participation agreements and related provider numbers) and transfer the same to Op-Cos immediately following the Closing, subject to obtaining all necessary third-party approvals.

Buyer acknowledges that certain mutually agreed upon assets of DCHS will be excluded from the Transaction including, (i) the rights to the name "Daughters of Charity Health System," (ii) the charitable foundations of the Hospitals and their respective assets, (iii) certain identified inter-company receivables, (iv) certain gifts and grants which are required to be maintained by a church and (v) other customary assets relating to pre-closing periods (e.g., bank accounts, tax refunds, retained records, etc.). Prior to Closing, DCHS would be required to utilize unrestricted cash to pay for agreed-upon operating expenses pursuant to an operating budget attached to the Definitive Agreements.

In addition, Op-Co Parent will assume specified liabilities (e.g., equipment leases, post-closing contractual obligations, risk pool obligations, utilities, current liabilities included in working capital and other specified liabilities). All other pre-closing liabilities of DCHS and its subsidiaries (the "DCHS Group"), including but not limited to accounts payable and off-balance sheet liabilities, will remain the liabilities of the DCHS Group.

It is contemplated that Op-Co Parent will create an employee stock ownership plan ("ESOP"). Each Op-Co will retain substantially all of the employees and will assume the existing collective bargaining agreements relating to their applicable Hospital on their existing terms and each employee will be given the opportunity to participate in the ESOP, subject to customary vesting conditions. Employees will own 100% of Op-Co through the ESOP which will be represented by a highly experienced and dedicated trustee who will be responsible for ensuring that Op-Co Parent and Op-Cos act in the best interests of the employees and that all contractual arrangements of the Op-Co entities are fair and equitable and structured on market terms.

- (b) **Prop-Co.** Prop-Co Parent, a California limited liability company ("Prop-Co Parent"), will acquire all real and personal property assets of each Hospital, as well as other assets not acquired by the Op-Cos (e.g., Other Entities (as defined below)) and form several subsidiary operating limited liability companies (each, a "Prop-Co"). Prop-Co Parent will contribute the various assets it acquires to individual Prop-Cos immediately following the Closing and such Prop-Cos will then lease hospital-related real and personal property assets to corresponding Op-Cos.

Prop-Co Parent will also acquire DCHS's other business entities (e.g., Caritas Business Services, St. Vincent Dialysis Center, Inc., Marillac Insurance Company, De Paul Ventures) ("Other Entities"). The acquisitions of the Other Entities would be

accomplished through asset purchases or equity purchases as set forth in the Definitive Agreement.

- (c) **Assets to be Acquired.** For purposes of clarity we have attached a sample asset allocation spreadsheet documenting which assets we envision being transferred to Op-Co Parent and Prop-Co Parent at the Closing and their expected values. The final and complete list of transferred assets will be reflected in the various schedule attachments to the Definitive Agreements and the attached are not meant as comprehensive lists.
- (d) **1206(l) Medical Foundation.** With respect to the Medical Foundation, Paladin does not have a 501(c)(3) entity set up that would be able to take ownership of the equity in the Medical Foundation, and we do not anticipate forming such an entity. Rather, we are supportive of either (i) bringing a 3rd party partner into the Transaction to acquire the Medical Foundation, or (ii) supporting the physicians currently affiliated with the Medical Foundation in structuring self-governance of the Medical Foundation. In either case, the Buyer Entities intends to assume and perform its obligations under related assigned contracts, including funding obligations and operational support.

The Definitive Agreement will include customary representations, warranties, indemnities and covenants during the pre-closing period, including the obligation to operate the Business in the ordinary course. Subject to completion of comprehensive confirmatory due diligence, the Buyer Entities will accept limited indemnification from DCHS and be satisfied exclusively through (and limited by) offsets against the Indemnity Note.

The Transaction would be subject to receipt by the parties of all necessary third-party consents, including expiration of HSR waiting periods, receipt of other consents to the transfer of material licenses and contracts and other matters described in this letter under the heading "Conditions Required to Consummate the Transaction" below.

Financing

Apollo/MidCap remains committed to underwriting the entire Transaction such that Paladin can close with a single source of capital and has completed substantially all of its due diligence. Apollo/MidCap has also participated in the review and comment on Definitive Agreements has expressed its approval and support of the revised terms set forth in this Proposal. We are confident that we can move quickly to a successful Closing with Apollo/MidCap's full support in the event DCHS chooses to move forward with the Transaction.

Remaining Diligence

Paladin, its capital sources and each of its respective advisors, have reviewed substantially all of the materials posted to the data room, and greatly appreciates the efforts of DCHS in producing the volumes of information posted to date. Paladin will continue to review due diligence materials on an expedited basis once it receives positive feedback regarding this letter, and believes its review will be completed in short order. To facilitate an expeditious process, it is anticipated that Seller and

its advisors will continue to cooperate fully with and facilitate Buyer's due diligence review as contemplated hereby, and will afford Buyer and its agents, representatives and capital partners a reasonable opportunity to access the data room to inspect, investigate and audit the Business, including, but not limited to, assets, liabilities, financial statements, cost reports, adjusted EBIDA, legal matters and proceedings, real estate matters, environmental matters, employee benefits matters, contracts (including but not limited to payor contracts), contingent liabilities, operations, relationships with employees, suppliers and customers (including interviews of the same), physicians and prospects; and Seller will promptly and completely provide all disclosures requested by or on behalf of Buyer.

Regulatory Considerations

Although Paladin has not identified any specific or material competitive or regulatory issues regarding the Transaction, our proposal is conditioned upon receipt of any regulatory approvals that are necessary to effect the Transaction, and which will be more fully described in the Definitive Agreement. It is currently anticipated that such conditions can be met without significant delay.

Conditions Required to Consummate the Transaction

The closing of the Transaction would be subject to:

- (a) Execution and delivery of one or more Definitive Agreement(s) and related documents and consents in a form acceptable to Seller and Buyer; and
- (b) Buyer's satisfaction (as determined in Buyer's sole discretion) with the results of its due diligence review; and
- (c) Customary conditions, including: (i) obtaining any necessary consents, approvals or releases from governmental bodies, Seller's lenders, bond agencies, lessors, major customers and suppliers and other third parties with respect to the Transaction; (ii) absence of pending or threatened material litigation, investigation or governmental proceeding regarding the Transaction; (iii) absence of any material adverse change in the business, financial condition, assets, operations or prospects of the Seller; (iv) satisfaction of all necessary title and environmental inspections related to the real property; and (iv) delivery of customary legal opinions, closing certificates and other documentation.

Miscellaneous

- (a) Documentation. The Definitive Agreement will include such representations, warranties, covenants, indemnifications and conditions that are customarily included in an agreement associated with comparable transactions.
- (b) Expenses. Buyer and Seller shall bear their own expenses in negotiating and closing the Transaction.
- (c) Confidentiality and Publicity. The terms and conditions of this letter and any information received by Buyer as part of the its due diligence of the Business shall

be subject to the previously executed confidentiality agreement dated March 3, 2014 by and between Buyer and Seller, which shall remain in full force and effect. No party shall issue any press release or other announcement regarding the Transaction unless such release or announcement has been mutually agreed to in writing by the parties or unless required by law.

- (d) Non-Binding Commitment. Except for the provisions of paragraph (b) through paragraph (e) of this Miscellaneous section, which shall be legally binding upon Buyer, its affiliates and capital partners, and Seller, and notwithstanding anything to the contrary contained in this letter, this letter is only for the sole purpose of setting forth a basis upon which the parties may be agreeable to proceeding toward a contemplated Transaction, and is not intended to be a legally binding contract or to impose any liabilities or obligations on any party. Other than as expressly indicated in the immediately preceding sentence, the legal obligations of the parties would arise only upon the execution of Definitive Agreements in forms and substance acceptable to the parties and their respective counsel. It is understood that this letter is not intended to set forth all of the terms of such Definitive Agreements.

- (e) Governing Law. This letter shall be governed by the internal laws of the State of California, without giving regard to its principles of conflicts of laws.

Paladin and Apollo/MidCap look forward to the opportunity to consummating a Transaction with DCHS on an expedited basis and are prepared to deliver a revised draft of the Definitive Agreement in short order upon our receipt of your acceptance of our revised terms. However, absent written notice from DCHS of its intention to proceed with the Transaction on an exclusive basis, the terms of this Proposal and our commitment to proceed with the Transaction on the terms set forth herein shall expire on September 25, 2014.

If you should have any questions or comments, please contact me at 310-414-2700.

Sincerely,

Joel L. Freedman
President
Paladin Healthcare Capital, LLC

cc: Eric Klein
James MacPherson
Nicholas Orzano
Garrett Fletcher

Attachment: Sample Asset Allocation Spreadsheet



Paladin Healthcare Capital, LLC

Sample Asset Allocation Spreadsheet

Assumed Assets and Liabilities			
Asset/ Liability Class (\$millions)	OLV of Assets	Book Value of Assets	Notes
Assumed Assets			
Eligible A/R	\$ 81.8	\$ 163.6	June 30, 2014 Consolidated Financials. Assumes OLV 50% of Book Value.
Inventory	\$ 21.3	\$ 21.3	June 30, 2014 Consolidated Financials
AR from Government Payors	\$ 21.1	\$ 21.1	June 30, 2014 Consolidated Financials
QAF	\$ 292.0	\$ 292.0	Assumes \$318mm less \$26mm paid to DCHS before closing. \$26mm Estimate from DCHS Cash Projections. \$318 from California Hospital Association QAF estimate.
Other Assets	\$ 9.7	\$ 14.7	June 30, 2014 Consolidated Financials. Obligated Group Only. OLV Per Hoillihan, who suggest some eliminations (up to 5mm).
Notes Receivable	\$ 1.5	\$ 1.5	June 30, 2014 Consolidated Financials
Restricted Cash - Capital/Debt Repayment	\$ 9.2	\$ 9.2	June 30, 2014 Consolidated Financials. Obligated Group Only.
Restricted Cash - Donation/Grants	\$ 3.1	\$ 3.1	June 30, 2014 Consolidated Financials. Obligated Group Only.
Marrillac - Other Current Assets	\$ 4.3	\$ 4.3	June 30, 2014 Consolidated Financials
Marillac - Restricted Cash - Donation/Grants	\$ 36.5	\$ 42.9	June 30, 2014 Consolidated Financials. Assumes OLV 85% of Book Value.
Equipment	\$ 68.4	\$ 136.8	June 30, 2014 Consolidated Financials. OLV 50% of equipment net depreciation.
Real Property	\$ 176.0	\$ 202.7	Estimate Market Value Based on Comps. Book Value from June 30, 2014 Consolidated Financials.
Total	\$ 724.9	\$ 913.1	
Assumed Liabilities			
Unfunded Pension Liability	\$ 255.1	\$ 255.1	Year End 2014 Unaudited Consolidated Financials
Total	\$ 255.1	\$ 255.1	

