

# Sutter Health and Affiliates

## Combined Financial Statements

Years Ended December 31, 1999 and 1998

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## Report of Independent Auditors

The Board of Directors  
Sutter Health and Affiliates

We have audited the accompanying combined balance sheets of Sutter Health and Affiliates as of December 31, 1999 and 1998, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Sutter Health and Affiliates' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Sutter Health and Affiliates at December 31, 1999 and 1998, and the combined results of their operations and changes in their net assets, and their cash flows for the years then ended in conformity with generally accepted accounting principles.

*Ernst & Young LLP*

March 10, 2000

# Sutter Health and Affiliates

## Combined Balance Sheets

(In Millions)

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
<b>Assets</b>		
Current assets:		
Cash and equivalents	\$ 161	\$ 106
Short-term investments	255	264
Patient accounts receivable (less allowance for doubtful accounts of \$86 in 1999 and \$69 in 1998)	510	467
Other receivables	81	90
Inventories	40	36
Property held for sale	22	-
Other current assets	18	18
Total current assets	<u>1,087</u>	981
Non-current investments	669	638
Property, plant and equipment, net	1,608	1,375
Other assets	157	163
	<u>\$ 3,521</u>	<u>\$ 3,157</u>
<b>Liabilities and net assets</b>		
Current liabilities:		
Short-term borrowings	\$ 93	\$ 44
Current maturities of long-term obligations	27	26
Accounts payable and accrued expenses	535	423
Estimated third-party settlements	65	99
Total current liabilities	<u>720</u>	592
Non-current liabilities:		
Long-term obligations, less current maturities	1,156	1,112
Other	163	130
Net assets:		
Unrestricted	1,233	1,096
Temporarily restricted	195	197
Permanently restricted	54	30
	<u>1,482</u>	1,323
	<u>\$ 3,521</u>	<u>\$ 3,157</u>

See accompanying notes.

## Sutter Health and Affiliates

### Combined Statements of Operations and Changes in Net Assets

*(In Millions)*

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
<b>Unrestricted net assets:</b>		
Unrestricted revenues, gains and other support:		
Patient service revenues	\$ 2,146	\$ 2,010
Capitation revenues	550	487
Other revenues	223	189
Total revenues	2,919	2,686
Operating expenses:		
Salaries and employee benefits	1,339	1,252
Purchased services	457	417
Supplies	366	335
Depreciation and amortization	160	143
Capitated purchased services	167	120
Provision for bad debts	109	94
Rentals and leases	53	54
Interest	52	54
Insurance	14	16
Other operating expenses	149	146
Unusual charges	2	12
Total operating expenses	2,868	2,643
Income	51	43

## Sutter Health and Affiliates

### Combined Statements of Operations and Changes in Net Assets (Continued)

(In Millions)

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
<b>Unrestricted net assets (Continued):</b>		
Income (page 3)	\$ 51	\$ 43
Change in net unrealized gains and losses on investments	(3)	15
Contribution of long-lived assets in connection with the Summit Medical Center affiliation	60	-
Net assets released from restrictions for equipment acquisition	37	12
Donated equipment	2	3
Other	9	(4)
Increase in unrestricted net assets before discontinued operations, cumulative effect of change in accounting principle and extraordinary item	156	69
Discontinued operations:		
Loss from operations	-	(5)
Loss on disposal, including provision of \$2 for operating losses during the phase-out period	(10)	-
Cumulative effect of change in accounting principle	(2)	-
Extraordinary loss from extinguishment of debt	(7)	-
Increase in unrestricted net assets	137	64
<b>Temporarily restricted net assets:</b>		
Contributions and investment income	62	70
Change in net unrealized gains and losses on investments	3	7
	(77)	(51)
Net assets released from restriction		
Other, including impact of Summit Medical Center affiliation	10	(1)
Increase (decrease) in temporarily restricted net assets	(2)	25
<b>Permanently restricted net assets:</b>		
Contributions	1	2
Other, including impact of Summit Medical Center affiliation	23	-
Increase in permanently restricted net assets	24	2
Increase in net assets	159	91
Net assets, beginning of year	1,323	1,232
Net assets, end of year	\$ 1,482	\$ 1,323

*See accompanying notes.*

Sutter Health and Affiliates  
 Combined Statements of Cash Flows

*(In Millions)*

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
<b>Operating activities</b>		
Change in net assets	\$ 159	\$ 91
Adjustments to reconcile change in net assets to net cash provided by operating activities:		
Noncash impact of Summit Medical Center affiliation	(97)	–
Extraordinary loss from extinguishment of debt	7	–
Depreciation and amortization	160	143
Change in net unrealized gains and losses on investments	–	(22)
Provision for bad debts	109	94
Increase in professional liability reserves	4	4
Equity in earnings on investments in health care-related businesses	(2)	(5)
Loss from impairment of long-lived assets	–	10
Increase in other non-current liabilities	10	15
Restricted contributions and investment income	(1)	(2)
Other	2	3
Net changes in operating assets and liabilities:		
Patient accounts receivable and other receivables	(105)	(139)
Inventories and other assets	(4)	5
Accounts payable, accrued expenses and estimated third-party settlements	15	15
Net cash provided by operating activities	257	212
<b>Investing activities</b>		
Payments for business acquisitions, net of cash and equivalents acquired	10	(94)
Purchases of property, plant and equipment	(282)	(231)
Purchases and sales or maturities of investments, net	37	(2)
Proceeds from sale of investments in health care-related businesses	–	5
Other	19	(21)
Net cash used in investing activities	(216)	(343)

Sutter Health and Affiliates

Combined Statements of Cash Flows (Continued)

(In Millions)

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
<b>Financing activities</b>		
Net increase (decrease) in short-term borrowings	\$ 49	\$ (26)
Payments of long-term obligations	(81)	(97)
Payments for legal defeasance of bonds	(201)	–
Proceeds from long-term obligations	254	268
Bond issuance costs and discount	(8)	(4)
Proceeds from restricted contributions and investment income	1	2
Net cash provided by financing activities	<u>14</u>	<u>143</u>
Net increase in cash and equivalents	55	12
Cash and equivalents at beginning of year	106	94
Cash and equivalents at end of year	<u>\$ 161</u>	<u>\$ 106</u>
<b>Supplementary disclosures of cash flow information and schedule of noncash investing and financing activities:</b>		
Cash paid during the year for interest (net of capitalized interest costs of \$5 in 1999 and \$10 in 1998)	\$ 49	\$ 39
Noncash investing and financing activities:		
Assets acquired (\$243 in 1999 and \$115 in 1998) in excess of liabilities assumed (\$156 in 1999 and \$21 in 1998) in connection with business acquisitions accounted for as purchases, exchanges or contributions of long-lived assets, excluding cash and equivalents	\$ 87	\$ 94

See accompanying notes.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements

December 31, 1999 and 1998

*(Dollars in Millions)*

### **1. ORGANIZATION**

Organization: Sutter Health is a California nonprofit multi-provider integrated health care delivery system headquartered in Sacramento, California which includes a centralized support group and various health care-related businesses operating in two divisions and seven service areas, principally in Northern California.

Sutter Health and its support affiliates and subsidiaries provide the following services: health care, education, administration and consulting.

Affiliates in the Eastern and Western divisions include acute care and psychiatric hospitals, skilled nursing facilities, medical foundations, fundraising foundations, and a variety of other specialized health care service providers. The acute care hospitals provide a full range of medical services (e.g., surgical, intensive care, emergency room and obstetrics). All emergency rooms provide emergency care, regardless of a patient's ability to pay. Sutter Health and its affiliates also serve their communities with programs including health education, health libraries, school-based clinics, home health care, hospice care, adult day care, prenatal clinics, community clinics and immunization services.

### **2. ACCOUNTING POLICIES**

Basis of Combination: The combined financial statements include the accounts of Sutter Health and affiliated corporations and subsidiaries ("Sutter"). All significant intercompany accounts and transactions have been eliminated in combination.

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents: Cash equivalents represent all highly liquid investments, including money market accounts. Financial instruments that potentially subject Sutter to concentrations of credit risk include cash equivalents and investments. Sutter places certain of its cash in banks that are federally insured in limited amounts and in investment-grade debt instruments, many of which are backed by the U.S. Government or other government agencies. Cash equivalents are stated at fair market value.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 2. ACCOUNTING POLICIES (Continued)

Investments: Investments consist principally of corporate notes and stocks, and U.S. Government and agency securities, all of which are other than trading and carried at fair market value. Certain investments are designated as assets held in trust. These include assets held by trustees in accordance with the indentures relating to long-term obligations and assets set aside in accordance with self-insurance requirements. In addition, certain investments are set aside by the appropriate governing boards for future capital improvements.

Patient Accounts Receivable: Sutter's primary concentration of credit risk is patient accounts receivable, which consist of amounts owed by various governmental agencies, insurance companies and private patients. Sutter manages the receivables by regularly reviewing its accounts and contracts and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross fee-for-service patient accounts receivable were as follows:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Medicare	21%	20%
Medi-Cal	12%	17%

Inventories: Inventories, which consist principally of medical supplies, are stated on the basis of cost determined by the first-in, first-out method, which is not in excess of market.

Property, Plant and Equipment: Property, plant and equipment are stated on the basis of cost, or in the case of donated items, on the basis of fair market value at the date of donation, less any impairment write-downs. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase values, change capacities or extend useful lives are capitalized, as is interest on amounts borrowed to finance such constructed assets.

Depreciation is computed by the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years for buildings and improvements and leasehold improvements, and from 3 to 20 years for equipment. Amortization of equipment under capital leases is included in depreciation expense.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

The application of Statement of Financial Standards (“SFAS”) No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,” resulted in unusual charges to Sutter’s 1998 operations of \$10 (none in 1999) related to long-lived assets held and used in operations and long-lived assets designated for sale. Long-lived assets held for sale are stated at the lower of cost or estimated fair value less costs of disposal. Certain medical office buildings held and used in operations were determined to be impaired as of December 31, 1998 due to high vacancy factors. The fair market values of these assets, and resultant impairment losses, were calculated based on discounted cash flow analyses or independent appraisals. As of December 31, 1999, property held for sale, other than that pertaining to discontinued operations (Note 3), consisted principally of land and buildings located in Palo Alto, California with an aggregate carrying value of \$22. These assets are under a contract of sale as of such date and management expects this sale to be consummated in 2000. As of December 31, 1998, assets to be disposed of (which were sold in 1999) included certain parcels of land and a medical office building whose aggregate carrying value was \$7.

Other Assets: Goodwill represents the excess of purchase price over the fair market value of net assets acquired and is being amortized over periods ranging from 5 to 20 years using the straight-line method. Realization of Sutter’s residual goodwill balance of \$25 as of December 31, 1999 (which excludes goodwill pertaining to discontinued operations, which was written-off in 1999 - Note 3) is dependent on generating sufficient operating cash flows at certain affiliates to which such balance relates. Based on current estimates, management believes that the aforementioned goodwill balance will be realized. The amount of goodwill considered realizable, however, could be revised in the near term if estimates of future operating cash flows are reduced. Unamortized financing costs associated with the issuance of long-term obligations are amortized ratably over the term of the respective obligations. Sutter has minority interests in various health care-related businesses. The majority of these investments are accounted for on the equity method and the assets, liabilities and results of operations of these unconsolidated investees are not material to Sutter’s combined financial statements.

Risk Management: Sutter maintains several self-insured medical and other benefit plans for certain employees and is self-insured for workers’ compensation for certain affiliates. Also, certain affiliates of Sutter participate in wholly owned self-insured captives for professional liability claims and comprehensive general liability. In addition, certain affiliates of Sutter purchase (a) workers’ compensation insurance coverage with nominal or no deductibles and (b) professional liability insurance coverage using both claims-made and modified occurrence-basis policies. The modified occurrence-basis policies

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

include prepaid tail coverage for seven years. The provisions for estimated workers' compensation, professional liability and comprehensive general liability claims include estimates of the ultimate costs for both reported claims and claims incurred but not reported, in accordance with actuarial projections based on past experience. Such claim reserves are based on the best data available to Sutter; however, in some cases, because of the lack of historical experience, these estimates are subject to a significant degree of inherent variability. Accordingly, there is at least a reasonable possibility that a material change to the estimated reserves will occur in the future. Such estimates are continually monitored and reviewed, and as reserves are adjusted, the differences are reflected in current operations. While the ultimate amount of workers' compensation, professional liability and general liability claims is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying combined financial statements are adequate to cover such claims. Sutter has entered into reinsurance agreements with independent insurance companies to limit its losses on workers' compensation, professional liability and comprehensive general liability claims. Reserves for reported and incurred but not reported professional liability claims, which are discounted using rates of 6% and 4% as of December 31, 1999 and 1998, respectively, amount to \$45 and \$41 as of December 31, 1999 and 1998, respectively. Management is aware of no potential professional liability claims whose settlement, if any, would have a material adverse effect on Sutter's combined financial position.

Other Liabilities: Other non-current liabilities consist of (a) insurance liabilities, including estimated liabilities for (i) professional liability losses and (ii) referral claims; (b) minority interests in net assets of subsidiaries; (c) obligations to return assets to local hospital districts, and (d) certain other liabilities.

Net Assets: All resources that are not restricted by donors are included in unrestricted net assets. Resources temporarily restricted by donors for specific purposes are reported as temporarily restricted net assets. When the specific purposes are achieved, either through passage of a stipulated time or the purpose for restriction is accomplished, they are reclassified to unrestricted net assets and reported as such in the combined statement of operations and changes in net assets. Resources temporarily restricted by donors for additions to land, buildings and equipment are initially reported as temporarily restricted net assets and are transferred to unrestricted net assets when expended. Donor-imposed restrictions which stipulate that the resources be maintained permanently are reported as permanently restricted net assets. Investment income related to these permanently restricted net assets is classified as either temporarily restricted or unrestricted based on the intent of the donor, or is added to the balance if required by the donor.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 2. ACCOUNTING POLICIES (Continued)

Temporarily restricted and permanently restricted net assets were maintained for the following purposes as determined by management:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Temporarily restricted:		
Capital projects, medical equipment and services	\$ <b>63</b>	\$ 51
Time restricted under annuity trust agreements	<b>43</b>	9
Rehabilitation medicine	<b>12</b>	11
Community benefit	<b>33</b>	97
Research and education	<b>44</b>	29
	<b>\$ 195</b>	\$ 197
Permanently restricted - Endowment	<b>\$ 54</b>	\$ 30

Donor Gifts: Unconditional promises to give cash and other assets are reported at fair market value at the date the promise is received. Conditional promises to give and indications of intentions to give are reported at fair market value at the date the gift is received (however, such amounts were not material at December 31, 1999 and 1998 and, accordingly, are not disclosed).

As of December 31, 1999, aggregate pledges receivable consisted of the following unconditional promises to give:

Pledges due in 2000	\$ 17
Pledges due 2001-2004	15
Pledges due after 2004	11
Less allowance for uncollectible pledges	(3)
	<b>\$ 40</b>

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

Gifts of long-lived operating assets, such as land, buildings, or equipment, are reported as unrestricted support and excluded from income, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated long-lived assets are acquired and placed in service.

Patient Service Revenues: Patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement programs with third-party payors. Estimated settlements under third-party reimbursement programs are accrued in the period the related services are rendered and adjusted in future periods, primarily as a result of final settlements.

Capitation Revenues: Sutter has agreements with various Health Maintenance Organizations (“HMOs”) to provide medical services to subscribing participants. Under these agreements, Sutter receives monthly capitation payments based on the number of each HMOs’ participants, regardless of services actually performed by Sutter. Certain of these agreements also contain provisions whereby additional amounts may be due or paid.

Premium Revenues: Premiums generated by Sutter’s discontinued HMO (Note 3) are recorded as revenue in the month for which enrollees are entitled to health care services. Premium revenue billed and/or collected in advance is deferred as unearned premium revenue, which is included in accrued expenses in the accompanying combined balance sheets. A portion of premiums is subject to possible retroactive adjustment. Provisions have been made for estimated retroactive adjustments to the extent the probable outcome of such adjustments can be determined.

Charity Care: Sutter provides medically necessary care to all patients who meet certain criteria under its charity care policy regardless of the patient’s ability to pay.

Performance Indicator: “Income,” as reflected in the accompanying combined statements of operations and changes in net assets, is a performance indicator. Income includes all changes in unrestricted net assets other than contributions of long-lived assets, unrealized gains and losses on investments, investment returns restricted by donors, discontinued

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

operations, cumulative effects of changes in accounting principles, extraordinary items and minimum pension liabilities. Unusual charges included in Income consist principally of losses from (a) impairment of long-lived assets and (b) restructuring of lease agreements.

Income Taxes: Sutter Health and most of its affiliates have been determined to be exempt organizations by the Internal Revenue Service, pursuant to Internal Revenue Code Section 501(c)(3), and the California Franchise Tax Board and, generally, are not subject to taxes on income. Certain activities of Sutter are subject to income taxes; however, such activities are not significant to the combined financial statements. With respect to its for-profit subsidiaries and taxable activities, Sutter records income taxes using the liability method under which deferred tax assets and liabilities are determined based on the differences between the financial accounting and tax bases of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the currently enacted tax rate expected to apply to taxable income in the periods in which the deferred tax asset or liability is expected to be realized or settled.

Fair Values of Financial Instruments: The methods and assumptions used by Sutter in estimating its financial instrument fair value disclosures, as well as the resultant amounts, are as indicated in Notes 5 and 8.

Adoption of New Accounting Pronouncements: In 1999, Sutter adopted SOP 98-5, "Reporting on the Costs of Start-Up Activities." SOP 98-5 requires costs of start-up activities, including organization costs, to be charged to expense as incurred. In accordance with SOP 98-5, Sutter's unamortized start-up costs as of January 1, 1999 of \$2 have been written-off through a charge to unrestricted net assets and classified as a cumulative effect of a change in accounting principle. Additional start-up costs incurred by Sutter in 1999 and charged to operating expenses were not significant.

In 1998, Sutter adopted SOP 98-1, "Accounting For the Costs of Computer Software Developed For or Obtained For Internal Use." SOP 98-1 requires the capitalization of certain costs incurred after the date of adoption in connection with developing or obtaining software for internal use. The adoption of SOP 98-1 did not have a material impact on Sutter's combined financial position.

Adoption of Other New Accounting Pronouncements in the Future: In 1998, Financial Accounting Standards Board ("FASB") issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." In 1999, the FASB issued SFAS No.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **2. ACCOUNTING POLICIES (Continued)**

136, "Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others." Sutter will adopt SFAS Nos. 133 and 136 in 2001 and 2000, respectively. Management does not believe that the adoption of these pronouncements will have a material impact on Sutter's combined financial position.

Reclassifications: Certain amounts in Sutter's 1998 combined financial statements have been reclassified to conform with the presentation of its 1999 combined financial statements.

### **3. DISCONTINUED OPERATIONS**

On May 13, 1999, Sutter decided to discontinue the operations of its indirect majority-owned HMO, Omni Healthcare, Inc. ("Omni"), and its indirect wholly-owned health and life insurance company, Sutter Preferred Health and Life Insurance Company ("SPH&L"). The enrollees of Omni and SPH&L were transferred to an unrelated insurance company in 1999, and Omni and SPH&L expect to phase-out their operations and exit the California market by December 31, 2000. In addition, effective May 14, 1999, Omni sold its rights to certain contracts and other intangible assets to the aforementioned insurance company for an agreed-upon amount in accordance with the terms of the Member Transfer and Asset Purchase Agreement executed on such date. The remaining assets of Omni and SPH&L are to be liquidated in future periods and consist of the following:

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 3. DISCONTINUED OPERATIONS (continued)

	<b>December 31, 1999</b>		
	<b>Historical</b>	<b>Allowance for Estimated Losses on</b>	<b>Net</b>
	<b>Cost Basis</b>	<b>Disposal</b>	<b>Book Value</b>
Current assets:			
Cash, cash equivalents and short-term investments	\$ 35	\$ —	\$ 35
Premium and other receivables	9	—	9
Other	1	—	1
	45	—	45
Non-current assets -			
Property and equipment	7	(7)	—
	\$ 52	\$ (7)	\$ 45

The aggregate liabilities of Omni and SPH&L, including accruals for estimated operating losses through the end of the anticipated phase-out period, were \$37 as of December 31, 1999. All of these liabilities are current, and they include reserves related to claims involving prepaid health care services formerly provided by Omni. Such claim reserves are based on the best data available to Sutter; however, these estimates are subject to a significant degree of inherent variability. Accordingly, there is at least a reasonable possibility that a material change to the estimated reserves will occur in the future. While the ultimate amount of health care expenses is dependent on future developments, management is of the opinion that the liability for health care claims payable recognized in the accompanying combined financial statements is adequate to cover such expenses.

Premium revenues generated by Omni and SPH&L were \$68 and \$192 during the years ended December 31, 1999 and 1998, respectively.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **4. BUSINESS COMBINATIONS**

Effective December 27, 1999, Sutter Health, Alta Bates Medical Center (“ABMC”), Alta Bates Health System and Sutter Health East Bay (“SHEB”) consummated an affiliation agreement originally executed on November 18, 1998 with Summit Medical Center (“Summit”). (In January 2000, the Attorney General of the State of California filed an appeal to overturn a previous decision by a federal judge which enabled this affiliation to be consummated on December 27, 1999. At present, no date has been set for oral argument in such appeal. Therefore, the ultimate outcome of this appeal and its effects, if any, on Sutter’s combined financial statements cannot presently be determined.) Sutter Health is the sole corporate member of SHEB and, pursuant to the terms of the affiliation agreement, SHEB became the sole corporate member of both Summit and ABMC. In addition, the individuals serving as trustees on the governing boards of SHEB, ABMC and Summit are the same. Under the terms of the affiliation agreement, Sutter Health also (a) guaranteed certain bonds and other indebtedness of Summit aggregating \$73 as of December 27, 1999 and (b) made a capital commitment to SHEB for a minimum of \$450 million over a ten year period that commenced on December 27, 1999. This affiliation has been accounted for partially as an exchange transaction (with respect to the aforementioned Summit indebtedness guaranteed by Sutter Health) and partially as a contribution of long-lived assets from Summit to Sutter, to the extent that the estimated fair value of Summit’s assets as of December 27, 1999 exceeded the estimated fair value of the aforementioned indebtedness guaranteed by Sutter Health. All of the assets and liabilities of Summit have been adjusted to their estimated fair values as of the date of affiliation. Sutter incurred legal and other costs associated with the Summit affiliation aggregating \$7 and \$2 in 1999 and 1998, respectively. Such costs have been charged to purchased services in the accompanying combined statements of operations and changes in net assets.

On July 30, 1998, Sutter acquired specified assets and assumed certain liabilities and other obligations from Davies Medical Center (“DMC”) in a transaction accounted for as a purchase. The aggregate purchase price consisted of \$29 in cash and the assumption of certain liabilities aggregating \$3, plus transaction costs incurred by Sutter. The acquired assets and liabilities of DMC have been adjusted to their estimated fair values as of the date of acquisition. Concurrent with this purchase transaction, DMC’s sole corporate member (Franklin Holding Corporation) agreed to provide Sutter with specified annual cash gifts during a prescribed period. Such annual cash gifts constitute time conditioned, temporarily restricted pledges, the net present value of which (\$17) Sutter recognized as pledges receivable and temporarily restricted net assets in 1998.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 4. BUSINESS COMBINATIONS (continued)

On January 15, 1998, Sutter acquired specified assets and assumed certain liabilities of Eden Township Hospital District (the "District") in a transaction accounted for as a purchase. Consideration for this purchase included fixed cash payments to either the District or its bond trustee aggregating \$65, certain variable cash payments to the District aggregating \$10 (which are payable in annual installments based on the operating income of the hospitals acquired from the District by Sutter) and the assumption of certain liabilities of the District aggregating \$18, plus transaction costs incurred by Sutter. The net present value of the aforementioned variable cash payments is indeterminate. Therefore, if such payments are made in future periods, they will be capitalized as additions to buildings (to the extent of their respective fair values at the date of acquisition) or goodwill and amortized on a straight-line basis over the remainder of the original estimated useful lives. Under the terms of the acquisition agreement, Sutter was also required to legally defease (using a portion of the aforementioned fixed cash payments) certain long-term obligations of the District aggregating \$35. The acquired assets and liabilities of the District have been adjusted to their estimated fair values as of the date of acquisition.

#### 5. INVESTMENTS

Investments are held for the following uses:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Assets held in trust:		
Principal, interest and other reserves held in trust under bond indentures	\$ 124	\$ 178
Other	10	8
Board designated funded depreciation and other internal designations	503	433
Investments	287	283
	924	902
Less current portion	(255)	(264)
	\$ 669	\$ 638

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 5. INVESTMENTS (Continued)

Investments consist of the following:

	December 31,			
	1999		1998	
	Cost	Fair Market Value	Cost	Fair Market Value
Money market funds and other cash equivalents	\$ 124	\$ 124	\$ 127	\$ 127
U.S. Government and agency securities	284	274	302	298
Corporate debt securities	275	272	259	263
Marketable equity securities	182	254	155	214
	\$ 865	\$ 924	\$ 843	\$ 902

The fair market values for investments listed above are based on quoted market prices.

Investment income is comprised of the following elements:

	Years Ended December 31,	
	1999	1998
Interest and dividends	\$ 47	\$ 47
Realized gains on sales of securities	22	12
	69	59
Less amounts included in changes in restricted net assets	(15)	(10)
Amounts included in income	54	49
Less interest earned on unspent bond project funds	(5)	(4)
	\$ 49	\$ 45

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 5. INVESTMENTS (Continued)

Sutter uses the specific identification method to compute realized gains and losses on U.S. Government and agency securities and corporate debt securities. Sutter uses the average cost method to compute realized gains and losses on marketable equity securities. Marketable equity securities are primarily held for endowments and future capital improvements.

#### 6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Land improvements	\$ 54	\$ 45
Leasehold improvements	77	193
Buildings and improvements	1,258	908
Equipment	1,170	1,029
	2,559	2,175
Less accumulated depreciation and amortization	(1,277)	(1,166)
	1,282	1,009
Land	131	106
Construction-in-progress (Note 15)	195	260
	\$ 1,608	\$ 1,375

#### 7. OTHER ASSETS

Other assets consist of the following:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Goodwill, net	\$ 25	\$ 40
Prepaid rent	19	22
Unamortized financing costs	27	22
Investments in health care-related businesses	12	11
Other	74	68
	\$ 157	\$ 163

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 8. LONG-TERM OBLIGATIONS

Long-term obligations consist of the following:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Hospital revenue bonds and Certificates of Participation under the Sutter Health Master Indenture of Trust, fixed interest at 4.0% to 6.1%, variable interest at 2.2% - 4.6%, due from 2012 to 2038 (net of discount of \$12 at both December 31, 1999 and 1998)	<b>\$ 950</b>	\$ 911
Hospital revenue bonds under the California Pacific Medical Center (“CPMC”) Master Indenture of Trust, fixed interest at 4.7% to 6.0%, due from 2014 to 2015 (net of discount of \$2 at both December 31, 1999 and 1998)	<b>95</b>	108
Hospital revenue bonds through the City of Modesto, fixed interest at 4.0% to 6.0%, variable interest based on daily rate (4.4% at December 31, 1999) due from 2012 to 2021	<b>37</b>	38
Hospital revenue bonds under the Summit Master Indenture of Trust, fixed interest at 4.1% to 6.0%, due in 2015	<b>71</b>	–
Borrowings under revolving credit, competitive advance and short-term loan placement facilities, as described below	<b>7</b>	56
Various collateralized and unsecured obligations	<b>19</b>	21
Obligations under capital leases	<b>4</b>	4
	<b>1,183</b>	1,138
Less current maturities	<b>(27)</b>	(26)
	<b>\$ 1,156</b>	\$ 1,112

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **8. LONG-TERM OBLIGATIONS (Continued)**

The aggregate estimated fair market values of Sutter's short-term borrowings and long-term obligations at December 31, 1999 and 1998 of \$1,218 and \$1,226, respectively, were established using discounted cash flow analyses based on (a) the current market yield to maturity for similar types of publicly traded debt issues and (b) Sutter's current incremental borrowing rates for all other debt instruments.

Certain affiliates of Sutter are members of the Obligated Groups of Sutter Health and CPMC. In addition, the assets of certain affiliates of Sutter are subject to the indebtedness of the Obligated Groups of Sutter Health and CPMC.

The Obligated Groups of Sutter Health and CPMC are not legal entities. However, under the terms of the California Health Facilities Financing Authority ("CHFFA") and California Statewide Communities Development Authority ("CSCDA") bonds, members of the two Obligated Groups are jointly and severally liable for the bonds. The related financing documents and various other debt agreements contain certain restrictive covenants requiring compliance by all members, including pledges of gross revenues.

During 1998, Eden Medical Center joined the Obligated Groups of Sutter Health and CPMC. There were no additions to the Obligated Groups of Sutter Health and CPMC during 1999; however, Summit joined such Obligated Groups during the first quarter of 2000.

In January 1999, Sutter issued \$138 of 1999 Series A CHFFA fixed rate bonds. Certain of the proceeds of this borrowing were used in connection with the acquisition of a new hospital campus and to legally defease the 1989 Series A CHFFA and 1990 Series A CHFFA bonds. In October 1999, Sutter issued \$106 of 1999 CSCDA Certificates of Participation, all of which are fixed rate bonds. Certain of the proceeds of this borrowing were used to legally defease the 1989 Series A Roseville Financing Authority, 1990 Series A and B CHFFA and 1996 Series C CHFFA bonds. As a result of these defeasance transactions, Sutter was legally relieved of its obligations under the respective bond indentures and, accordingly, it recognized an extraordinary loss of \$7 in 1999.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 8. LONG-TERM OBLIGATIONS (Continued)

Sutter has entered into interest rate swap agreements with aggregate notional principal amounts of \$586 and \$436 at December 31, 1999 and 1998, respectively. Such swap agreements were used to convert fixed or variable interest rates on long-term obligations to variable rates ranging from 5.46% to 6.20% and fixed rates ranging from 5.04% to 5.10% at December 31, 1999. Under the terms of the swap agreements, Sutter pays the agreed-upon variable or fixed interest rates and receives fixed or variable payments equal to the interest rates on the respective long-term obligations. At December 31, 1999 and 1998, the aggregate fair market values of the swaps were net receivables (payables) of \$(11) and \$2, respectively. The interest rate differential to be received or paid is recognized over the terms of the swap agreements (which expire between 2000 and 2015) as an adjustment of interest expense.

Aggregate maturities of long-term obligations, excluding capital leases and bond discounts, are as follows as of December 31, 1999:

2000	\$	25
2001		30
2002		28
2003		26
2004		27
Thereafter		1,057
	\$	<u>1,193</u>

Sutter has a \$100 revolving line of credit and competitive advance facility, as well as a \$50 short-term loan placement facility, with a syndicate of banks under which \$100 has been borrowed in total as of both December 31, 1999 and 1998. \$60 and \$44 of such borrowings outstanding as of December 31, 1999 and 1998, respectively, were repaid using existing working capital in January 2000 and 1999, respectively. Sutter intends to repay an additional \$33 million of the borrowings outstanding as of December 31, 1999 later in 2000 using the proceeds of a planned real estate sale (Note 2 - Property, Plant and Equipment). Accordingly, such borrowings are classified as current liabilities in the accompanying combined balance sheets as of December 31, 1999 and 1998. All other borrowings under these credit facilities have been excluded from current liabilities because Sutter intends that such amounts will remain outstanding under such credit facility (which expires December 27, 2001) for an uninterrupted period extending beyond one year from the respective balance sheet dates, except for amounts repaid using (a) the proceeds of new long-term obligations, (b) the proceeds from the liquidation of non-current investments or (c) working capital provided by operations subsequent to the respective balance sheet dates.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 9. LEASES

Sutter leases various land, buildings, office space, and equipment. The leases expire at various times and contain certain contingent rental provisions, guarantees and various renewal options. These leases are classified as either capital leases (which are not material as of December 31, 1999 and 1998) or operating leases based on the terms of the respective agreements.

Certain of the aforementioned operating leases relate to acute care facilities leased from various municipalities. Such operating lease agreements require Sutter to make specified capital improvements to the municipalities' facilities at various times.

Future minimum payments (net of income from subleases), by year and in the aggregate, under noncancellable operating leases with terms of one year or more consist of the following as of December 31, 1999:

2000	\$	50
2001		44
2002		40
2003		33
2004		28
Thereafter		43
	\$	<u>238</u>

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

### 10. PATIENT SERVICE AND MANAGED CARE REVENUES

Sutter has agreements with third-party payors that provide for payments to Sutter at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Medicare* - Inpatient acute care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per diagnosis. These rates vary according to a patient classification system that is based on clinical, diagnostic, and other factors. Inpatient nonacute services, certain outpatient services and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. Sutter is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by the Medicare fiscal intermediary. Sutter's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review. Sutter's Medicare cost reports have been audited by the Medicare fiscal intermediary through December 31, 1997.
- *Medi-Cal* - Inpatient and outpatient services rendered to Medi-Cal program beneficiaries are reimbursed either under contracted rates or reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by Medi-Cal. Sutter's Medi-Cal cost reports have been audited by the Medi-Cal fiscal intermediary through December 31, 1997.
- Adjustments from finalization of prior-year cost reports from both Medicare and Medi-Cal resulted in increases in patient service revenues of approximately \$20 and \$11 for the years ended December 31, 1999 and 1998, respectively.

Gross patient charges, including charges related to capitated patients, from the Medicare and Medi-Cal programs accounted for the following percentages of Sutter's gross patient service revenues:

	Years Ended December 31,	
	1999	1998
Medicare	35%	35%
Medi-Cal	13%	13%

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 10. PATIENT SERVICE AND MANAGED CARE REVENUES (Continued)

Laws and regulations governing the Medicare and Medi-Cal programs are complex and subject to interpretation. Sutter believes that it is in compliance with all applicable laws and regulations and is not aware of any significant pending or threatened investigations involving allegations of potential wrongdoing. While no such significant regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medi-Cal programs.

Sutter also has entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to Sutter under these agreements includes capitated arrangements, prospectively determined rates per diagnosis, discounts from established charges, and prospectively determined daily rates.

#### 11. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED)

The following is a summary of management's estimated costs of providing traditional charity care and benefits to the community:

	1999		1998	
	Amount	% of Net Patient Service Revenues*	Amount	% of Net Patient Service Revenues*
Traditional charity care	\$ 17	0.63%	\$ 16	0.64%
Unpaid costs of public programs:				
Medicare	\$ 54	2.00%	\$ 44	1.76%
Medi-Cal	96	3.56	104	4.17
MIA	14	0.52	9	0.36
	\$ 164	6.08%	\$ 157	6.29%
Other:				
Nonbilled services	\$ 11	0.40%	\$ 8	0.32%
Education and research**	18	0.68	18	0.72
Cash and in-kind donation	4	0.15	2	0.08
Other community benefits	4	0.15	7	0.28
	\$ 37	1.38%	\$ 35	1.40%
Total community benefits	\$ 218	8.09%	\$ 208	8.33%

\* Net patient service revenues include capitation revenues.

\*\* Education and research costs reported herein consist of gross costs of \$43 less related revenues of \$25.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### 12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS

Sutter sponsors or participates in various employee benefit plans, including noncontributory defined benefit plans and several contributory defined contribution plans. Sutter's total retirement benefit expense was \$26 and \$17 for the years ended December 31, 1999 and 1998, respectively.

The changes in benefit obligations and plan assets for Sutter's noncontributory defined benefit retirement plans are as follows:

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
Projected benefit obligation at beginning of year	\$ 415	\$ 351
Effect of change in measurement date	(5)	-
Service cost	24	21
Interest cost	29	26
Actuarial losses (gains)	(37)	30
Benefits paid	(15)	(13)
Projected benefit obligation at end of year	411	415
Fair value of plan assets at beginning of year	379	368
Effect of change in measurement date	(22)	-
Actual return on plan assets	62	23
Employer contributions	4	-
Benefits paid	(15)	(12)
Fair value of Plan assets at end of year	408	379
Funded status of the plans	(3)	(36)
Unrecognized net actuarial loss (gain)	(39)	13
Unrecognized net transition asset	(3)	(5)
Unrecognized prior service cost	-	(1)
Minimum pension liability	-	(8)
Net accrued retirement benefit cost at end of year	\$ (45)	\$ (37)

During 1999, Sutter changed the measurement date for plan assets, pension obligations and net periodic pension cost associated with its primary noncontributory defined benefit retirement plan, the Sutter Health Retirement Plan (the "Plan"), from December 31 to September 30.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

**12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)**

Sutter's net accrued retirement benefit cost balances consist of the following elements:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Accrued retirement benefit cost	\$ (47)	\$ (39)
Prepaid retirement benefit cost	2	2
	<u>\$ (45)</u>	<u>\$ (37)</u>

Several of Sutter's noncontributory defined benefit retirement plans have benefit obligations in excess of plan assets, as follows:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Projected benefit obligation	\$ 386	\$ 390
Fair value of plan assets	\$ 378	\$ 353

The weighted average assumptions used by Sutter's noncontributory defined benefit plans were as follows:

	<b>December 31,</b>	
	<b>1999</b>	<b>1998</b>
Discount rates	<b>6.75-7.50%</b>	6.75-7.25%
Rates of compensation increase	<b>4.0%</b>	4.0%
Expected long-term rates of return on plan assets	<b>9.0%</b>	9.0%

The components of Sutter's net periodic benefit cost associated with its noncontributory defined benefit retirement plans are as follows:

	<b>Years Ended December 31,</b>	
	<b>1999</b>	<b>1998</b>
Service cost	\$ 24	\$ 21
Interest cost	30	26
Expected return on plan assets	(32)	(32)
Amortization of prior service cost	(1)	(3)
Transition asset recognition	(2)	(1)
Recognized net actuarial gains	1	-
Benefit cost	<u>\$ 20</u>	<u>\$ 11</u>

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)**

CPMC is a member of a multiemployer defined benefit retirement plan. For the multiemployer plan as a whole, the net assets available for benefits exceeded the actuarially computed value of vested benefits as of the most recent actuarial valuation (January 1, 1997). CPMC's funding policy is to contribute the minimum funding required by the Employee Retirement Income Security Act of 1974 and to eliminate the underfunded position of a former plan over a five-year period. The net pension benefit associated with CPMC's multiemployer plan was \$1 in both 1999 and 1998.

Sutter maintains various defined contribution plans for eligible employees. Sutter's contributions to such plans were \$7 in both 1999 and 1998.

In addition to providing pension benefits, Sutter provides certain health care and health insurance benefits for eligible retired employees and certain of their relatives. The postretirement benefit obligations and costs relating to these benefits are not significant to Sutter's combined financial statements.

#### **13. INCOME TAXES**

Deferred income taxes, which as of December 31, 1999 and 1998 have a net carrying value of zero, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 1999 and 1998, Sutter had deferred tax assets of \$34 and \$36, respectively, relating principally to net operating loss carryovers. As of both December 31, 1999 and 1998, such deferred tax assets were offset by a valuation allowance of \$34. As of December 31, 1998, such deferred tax assets were also offset by deferred tax liabilities of \$2, which related principally to differences between the financial reporting and tax bases of acquired assets (there were no deferred tax liabilities as of December 31, 1999). The aforementioned valuation allowance increased by \$5 during the year ended December 31, 1998 (there was no change in such valuation allowance in 1999).

Federal net operating loss carryovers totaled \$85 at December 31, 1999 and will expire between 2004 and 2015. State net operating loss carryovers totaled \$27 at December 31, 1999 and will expire between 2000 and 2004.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### 14. FUNCTIONAL CLASSIFICATION OF EXPENSES

The following is a summary of management's functional classification of Sutter's expenses:

	Years Ended December 31,	
	1999	1998
Health services	\$ 2,615	\$ 2,394
General and administrative	251	237
Unusual charges	2	12
	<u>\$ 2,868</u>	<u>\$ 2,643</u>

### 15. CONTINGENCIES AND COMMITMENTS

Contingencies: Marin General Hospital ("MGH") leases a hospital in Greenbrae, California from Marin Health Care District (the "Marin District") pursuant to a lease between MGH and the Marin District (the "Marin Lease"). MGH, Marin Community Health and Sutter Health are defendants in a lawsuit filed by the Marin District in 1997 which seeks, among other things, a judgment declaring that the Marin Lease and an Agreement for Transfer of Assets between the Marin District and MGH are void and that the Marin District is entitled to ownership and possession of the hospital and assets transferred and all proceeds and products of the hospital lease and assets transferred. On October 9, 1998, the Sacramento Superior Court granted motions of MGH and Sutter Health for partial summary adjudication. By its order, the Sacramento Superior Court ruled that the Marin District's claims that the Marin Lease and asset transfer were void because of alleged violations of California Government Code Section 1090 were barred by applicable statutes of limitations. On October 14, 1999, judgment was entered for the defendants by the Sacramento Superior Court, and the Marin District filed and appealed the judgment insofar as it concluded that the claims based on Government Code Section 1090 were barred by applicable statutes of limitation. Briefing has been completed, but the Court of Appeal has not yet set the case for hearing.

Mills-Peninsula Health Services ("MPHS") leases Mills-Peninsula Medical Center in Burlingame, California from Peninsula Health Care District (the "Peninsula District") pursuant to a lease between MPHS and the Peninsula District (the "Peninsula Lease"). MPHS is a defendant in a lawsuit filed by the Peninsula District in 1997 which seeks, among other things, a declaration that certain contracts relating to the consolidation of the hospital and medical facilities and operations of the Peninsula District and MPHS are void and canceled, including the 1985 Agreement for Consolidation of Assets and

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **15. CONTINGENCIES AND COMMITMENTS (Continued)**

Liability, the 1985 Lease of Peninsula Hospital, the 1997 Amended Lease of Peninsula Hospital, a 1985 cash donation from the Peninsula District to Mills-Peninsula Foundation, and certain 1985 donations of property from the Peninsula District to MPHS, and a declaration that the Peninsula District is entitled to ownership and possession of the assets transferred by the foregoing contracts and documents, including all the real property, improvements and personal property, both tangible and intangible, cash and liquid assets, all proceeds and products thereof, and all substitutions and replacements for the same. Subsequent to the filing of this lawsuit, the San Mateo Superior Court allowed both Sutter Health and the Mills-Peninsula Physicians Group, Inc. ("MPPG") to intervene as defendants. On September 5, 1997, the San Mateo Superior Court heard arguments on a demurrer to the complaint filed by MPHS and joined in by Sutter Health and MPPG. On November 13, 1997, the San Mateo Superior Court sustained the demurrer without leave to amend the complaint. The Peninsula District has filed a motion requesting that the San Mateo Superior Court reconsider its decision. The motion asserts that the stipulated judgment that the San Mateo Superior Court relied on in sustaining the demurrer is invalid under California Government Code Section 1090 because certain parties who approved the stipulation had an interest in it. The Peninsula District and the District Attorney of San Mateo County, who was a party to the stipulated judgment, moved to vacate the stipulated judgment on the same grounds. On November 19, 1998, the San Mateo County Superior Court issued an order granting the motion to vacate. MPHS and Sutter Health have appealed this order. No date has yet been set for the hearings on the appeal or the hearing on the motion for reconsideration.

It is difficult to predict either the outcome of the MGH and MPHS litigation or the effect such litigation might have on Sutter's combined financial position and results of operations, but a negative outcome could be material.

Sutter Health and CPMC are defendants in a lawsuit filed by St. Luke's Hospital in 1999, in San Francisco County Superior Court. In its lawsuit, St. Luke's Hospital alleges that CPMC's agreement with Brown & Toland Medical Group is anti-competitive because the agreement includes an exclusivity clause for full-risk health plan arrangements. St. Luke's Hospital seeks injunctive relief, unspecified damages, attorneys' fees, restitution through a constructive trust and costs of suit. The action is scheduled to be tried in September of 2000. This litigation is at an early stage and it is difficult to predict either the outcome of the litigation or the effect such litigation might have on Sutter's combined financial position and results of operations, but a negative outcome could be material.

# Sutter Health and Affiliates

## Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

### **15. CONTINGENCIES AND COMMITMENTS (Continued)**

Sutter is involved in other litigation, as both plaintiff and defendant, and other routine labor matters, tax examinations and regulatory examinations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters should be resolved without a material adverse effect on Sutter's combined financial position.

Sutter in the ordinary course of business enters into various incentive-based risk sharing agreements with managed care payors and other providers. These agreements require retroactive settlement based on data which may not be available or finalized until all claims are processed. Settlement amounts have been estimated for such risk-based incentives based on available information. However, it is reasonably possible that these estimates may change in the near term.

As of December 31, 1999, approximately 28% of Sutter's employees are represented by collective bargaining units. Employee strikes or other adverse labor actions may have an adverse impact on Sutter's operations in the future.

Commitments: Sutter's combined budgeted capital expenditures, as approved or committed by the Board of Directors, for the period from January 1, 2000 to December 31, 2004 amount to approximately \$375. Such capital expenditures will be financed by funds from various bond issues and certain investments, as designated by Sutter's Board of Directors, for capital improvements.

Sutter is in the process of reviewing the seismic safety of its facilities. Because of the declining utilization resulting from the implementation of managed care and planned replacement of older facilities, management does not anticipate that compliance with certain legislation adopted in California during 1994 (that generally requires each acute care hospital in the State to either comply with new hospital seismic safety standards or cease acute care operations by January 1, 2008) will have a material adverse effect on Sutter's combined financial position. Management expects that Sutter, will spend approximately \$330 through 2008 in replacement and upgrading of facilities to comply with the new seismic safety standards.

As of December 31, 1999, Sutter had irrevocable standby letters of credit aggregating \$120 and \$69 to (a) collateralize certain long-term obligations aggregating \$125 and (b) satisfy legal requirements for self-insured workers' compensation plans and for other purposes, respectively.

## Sutter Health and Affiliates

### Notes to Combined Financial Statements (Continued)

*(Dollars in Millions)*

#### **16. SUBSEQUENT EVENTS**

Effective January 1, 2000, the Plan (Note 12) was amended and restated to become a cash balance plan (the "CBP"). Each participant of the Plan has been given a one-time option to either (a) continue accruing benefits under the Plan (grandfather election) or (b) have his/her total accrued benefit converted to a beginning account balance under the CBP, and accrue future benefits under the CBP. The CBP provides each participant with a benefit initially based upon the participant's account balance under the Plan. Each participant's account balance will increase each year by the (a) additional benefit accrued by the participant for the year, if any, weighted by years of service and (b) interest credit. Distributions from the CBP will be made in the form of a single life annuity, a joint and 50% or 100% survivor annuity (for married participants only) or a lump sum. Management expects the impact of the aforementioned amendment on Sutter's combined financial position and results of operations to be immaterial.

Sutter continues to negotiate affiliations with certain acute care facilities, physician groups and other health care-related organizations.

#### **17. YEAR 2000 ISSUE (UNAUDITED)**

Sutter makes this Year 2000 ("Y2K") Readiness Disclosure Statement pursuant to public law 105-271.

In prior years, Sutter disclosed the nature and progress of its plans to become Y2K ready. In late 1999, Sutter completed its Y2K-related remediation and testing of systems and equipment. As a result of its planning and implementation efforts, Sutter experienced no significant disruptions in mission critical information technology and non-information technology systems and equipment and believes those systems and equipment successfully responded to the Y2K date change. Sutter's information technology expenditures were approximately \$84 and \$82 during 1999 and 1998, respectively. Expenses incurred by Sutter in connection with remediating its systems and equipment relative to Y2K are included in these amounts. Sutter is not aware of any material problems resulting from Y2K issues, either with its internal systems and equipment, or the products and services of third parties. Sutter will continue to monitor its mission critical computer applications and equipment and those of its suppliers and vendors throughout the Year 2000 to ensure that any latent Y2K matters that may arise are addressed promptly.