

October 18, 2021



Miriam Weizenbaum
Chief, Civil Division
Rhode Island Office of Attorney General
150 South Main Street
Providence, RI 02903

RSM US LLP

Re: Prospect Medical Holdings Inc. Hospital Conversion Monitorship: Reduction in CAPEX Funds for the period through June 30, 2021

Dear Ms. Weizenbaum, Esq.:

RSM US LLP (“RSM” or “we” or “us,” or “our”) was engaged to assist Rhode Island Office of Attorney General (“Attorney General”, “you”, “your”), pursuant to our engagement letter dated August 23, 2021 (the “Engagement Letter”), with respect to your monitorship of Chamber Inc.; Ivy Holdings Inc.; Ivy Intermediate Holdings, Inc.; Prospect Medical Holdings, Inc.; Prospect East Holdings, Inc.; Prospect East Hospital Advisory Services, LLC; Prospect CharterCARE, LLC; Prospect CharterCARE SJHSRI, LLC; Prospect CharterCARE RWMC, LLC (collectively “the Entities”) in connection with your Hospital Conversions Act Decision dated June 1, 2021, (the “Decision”).

The Attorney General retained RSM as hospital conversion monitoring consultant (“Consultant”) to assist the Attorney General in monitoring compliance of the conditions of approval associated with its Decision to approve a buy-out of the majority shareholders of the parent corporation to Prospect Medical Holdings, Inc. (“Prospect”) and Prospect’s control of the facilities now known as Roger Williams Medical Center (“RWMC”), Our Lady of Fatima Hospital (“OLF”) (collectively “Rhode Island Hospitals”). The Attorney General’s conditions of approval include, but are not limited to, implementing the buy-out transaction as proposed, financial commitments, operating covenants, board, and other governance requirements, and required notices.

As hospital conversion consultants we were asked to assist you in your assessment as to whether Entities meet conditions relative to your approval of the buy-out. The following report contains our analysis based upon procedures that we performed from engagement initiation through the date of this letter with respect to Prospect’s operations through June 30, 2021 and Prospect’s compliance with specific conditions indicated in our report. Our analysis was based on the guidance provided by the Attorney General with respect to relevant conditions contained in the Decision.

Our procedures, observations, and recommendations are provided further within the body of the report. Our analysis was reliant on information and representations from Prospect. The procedures performed do not constitute an audit, review or compilation of Client’s financial statements or any part thereof.

The attached report contains descriptions of our analyses, resulting observations and recommendations. Should you have any questions, please do not hesitate to contact me.

Sincerely,

Greg Naviloff
Partner

cc: Jessica Rider

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I. Background

This report contains the results of RSM US, LLP (“RSM”, or “we” or “us,” or “our”), as hospital conversion consultant engaged to assist Rhode Island Office of Attorney General (“Attorney General”), with your evaluation of Prospect Medical Holdings, Inc. (“Prospect” or “PMH”) compliance with the requirements for the \$8 million reduction in CAPEX Funds from escrow pursuant to Condition 6.4(a) of the Attorney General’s Hospital Conversions Act Decision dated June 1, 2021 (“Decision”).¹ In evaluating compliance, we also considered the requirements of Conditions 5.3 and 5.4. The definitions associated with each of these Conditions are presented in Exhibit 1.

As part of our evaluation, we considered the following measures of success,² as discussed with and agreed upon with the Attorney General, to form Consultant’s recommendation as to whether a reduction of the Escrows/Letters of Credit (Condition 6.4) and/or a draw of the Escrows/Letters of Credit (Conditions 6.5(b) and 6.6(d)), is appropriate.

II. Procedures

RSM established with the following Measures of Success associated with the following relevant Conditions:

Condition 5.3 Measure of Success:

- 1) Did Prospect spend the required amounts on CAPEX for the applicable periods?
- 2) Were reductions properly applied pursuant to Condition 6.4?

Condition 5.4 Measure of Success:

- 1) Did Prospect only utilize up to \$27 million of PACE financing towards its CAPEX requirements?

With respect to these two conditions, we collected the following information and performed the following procedures to evaluate whether Prospect successfully met each condition:

Condition 5.3 Procedures Performed:

- 1) Obtained and read Prospect’s capitalization accounting policy to assess conformity with generally accepted accounting principles (“GAAP”).
- 2) Obtained and analyzed Prospect’s detailed schedule of capital expenditures (“CAPEX”).
- 3) Agreed Prospect’s claimed capital expenditures to general ledger fixed asset accounts.
- 4) Obtained and inspected relevant capital expenditure documents related to a selection of capital expenditure items totaling approximately \$10,010,000.
- 5) Evaluated whether treatment of selected capital expenditures is consistent with Prospect’s capitalization accounting policy.

Condition 5.4 Procedures Performed:

- 1) Inquired as to the funding source for all capital expenditures.

¹ The Attorney General’s Hospital Conversions Act Decision dated June 1, 2021 involves the entities Chamber Inc.; Ivy Holdings Inc.; Ivy Intermediate Holdings, Inc.; Prospect Medical Holdings, Inc.; Prospect East Holdings, Inc.; Prospect East Hospital Advisory Services, LLC; Prospect CharterCARE, LLC; Prospect CharterCARE SJHSRI, LLC; Prospect CharterCARE RWMC, LLC (collectively “the Entities”).

² As defined in State of Rhode Island Office of Attorney General – Prospect/Chamber & Ivy Work Plan and applicable under the circumstances.

- a. Reviewed CAPEX schedules provided by Prospect that reflected CAPEX projects funded with PACE financing.

III. Observations, Findings and Recommendations

Based on the procedures performed, Prospect was required to spend not less than \$12.0 million in CAPEX for the Rhode Island Hospitals required under Condition 6.4(a) for the period from October 1, 2019 through June 30, 2021. The Decision defines Rhode Island Hospital to include Williams Medical Center (“RWMC”), Our Lady of Fatima Hospital (“OLF”) (collectively “Rhode Island Hospitals”).

The table below summarizes Prospect’s reported CAPEX spending as well as required adjustments to Prospect’s reported amount based on the procedures described above.

Table 1: CAPEX spending, from October 1, 2019 through June 30, 2021, as reported by Prospect

	Routine			Strategic			Total
	CCHP	RWMC	OLF	CCHP	RWMC	OLF	
New Equipment/New Facilities	\$ 11,993	\$ 187,133	\$ 284,124	\$ -	\$ 878,859	\$ 1,364,000	\$ 2,726,109
Equipment Replacement	222,029	1,375,473	1,884,193	-	-	-	3,481,695
Facility Renovation	-	1,522,851	2,422,363	55,723	1,289,770	31,177	5,321,884
Information Systems & Licenses	1,657,119	676,676	640,267	-	78,070	-	3,052,132
Total CAPEX per Prospect	\$1,891,141	\$3,762,133	\$5,230,947	\$55,723	\$2,246,699	\$1,395,177	\$14,581,820
					Less CCHP		(1,946,864)
				Total Rhode Island Hospitals Only			\$12,634,956
				Excludable CAPEX Items see Table 2 below			(7,894)
				Total Rhode Island Hospitals Only (excluding Table 2 spending)			12,627,062
				Excluded Software License ³ see Table 3 below			(586,461)
				CAPEX, as adjusted			\$12,040,601

CCHP – CharterCARE Health Partners
RWMC – Roger Williams Medical Center
OLF – Our Lady of Fatima

³ Software license should be accounted for as prepaid expense, pursuant to Accounting Standards Codification (ASC) 350-40 Internal Use Software.

Table 2: Excludable CAPEX (not meeting the definition under the Conditions):

Sample	Item	Description	Amount
67	Cepheid	Prospect appears to have included the same use tax (associated with equipment that it had purchased) two times in its listing of capital expenditures. Prospect recorded equipment that it purchased as capital expenditure, inclusive of use tax. Prospect separately recorded this use tax (associated with the same equipment that was purchased). The use tax amount was already included in the initial equipment purchase amount that was capitalized.	7,894
		Total	\$ 7,894

Table 3: 3M Encompass software amounts:

Type	Amount	CCHP	RI Hospitals	Accounting Classification
Software	\$ 634,475	\$ 48,014	\$ 586,461	Capitalized
Implementation	268,561	221,624	46,937	Capitalized
Training	88,241	68,125	20,116	Expensed
Support and Maintenance	18,342	18,342	-	Expensed
Total Amount	\$ 1,009,620	\$ 356,106	\$ 653,514	
Total Amount Expensed	\$ 106,583	\$ 86,467	\$ 20,116	
Total Amount Capitalized	\$ 903,037	\$ 269,639	\$ 633,398	

RSM observed that Prospect licensed and implemented 3M Encompass software. Prospect spent \$586,461 to license the software for use by the Rhode Island Hospitals. While Prospect capitalized and included the licensing amount within Prospects reported CAPEX, licenses do not represent capital investments (i.e., property, plant and equipment). Based on GAAP, the expenditure should be accounted for as prepaid expense, pursuant to Accounting Standards Codification (ASC) 350-40 Internal Use Software.

Additionally, during our review, we noted that Implementation and Training were not separate items on the 3M invoices, but rather were combined. According to Prospect, such items were allocated 70% to Implementation and 30% to Training based on estimates provided by 3M and on prior experience on similar IT projects (e.g., consistent with Prospect IT department employee recommendations).

Findings: Compliance Status Associated with Conditions

Compliance Status 5.3: Compliant. Prospect represents that all capitalized equipment has been placed in service. RSM observed items within Prospect's reported CAPEX amount that did not qualify as CAPEX as defined in the Decision and as stipulated within the Conditions. When evaluating CAPEX, the merits of capitalizing each selected expenditure are assessed in accordance with the definition of CAPEX, based on documentation provided, on a case-by-case basis.

As discussed above, RSM found that the cumulative amount of Prospect's CAPEX for the Rhode Island Hospitals, was \$12,040,601 (see Table 1), or \$40,601 greater than the amount stipulated in Condition 5.3 (\$12 million between October 1, 2019, and June 30, 2021).

Compliance Status 5.4: Compliant. Prospect represents that \$5.1868 million in CAPEX was funded from PACE financing.

Compliance Status 6.4(a): Compliant. The Attorney General notified us that the Attorney General gave Prospect and LGP an extension to provide the Letters of Credit and or Escrows under Conditions 6.2 and 6.3. Therefore, those Letters of Credit and or Escrows did not need to be provided to receive a reduction pursuant to Condition 6.4(a). All funds required pursuant to the Decision continue to remain in the Interim Escrows pursuant to Condition 6.1.

Recommendations:

Prospect should evaluate its accounting and record retention policies with respect to fixed asset capitalization particularly with respect to subjective allocations that may exist between CAPEX and OPEX categorization.

Exhibit 1 – Applicable Conditions⁴

VI. Conditions, Definitions

“CAPEX” shall mean routine and strategic capital investments recognized by GAAP that are limited to the following, unless otherwise approved by the Attorney General: new equipment, equipment replacement, facility renovation, new facilities, construction in progress, medical office space, implementation of new services, information systems and licenses, physician practice acquisitions up to but no greater than \$5 million during the Conditions and Monitoring Period, and shall include commitments incurred pursuant to capital financing leases.

VI. Conditions – II. Financial Conditions

5. Financial Commitment: Leonard Green, solely with respect to Condition 5.1, and Prospect shall provide the following support (collectively, the “Financial Commitment”) to PCC:

5.1 Provide for the Escrows and/or Letters of Credit as set forth in Condition 6.

5.2 Ensure payment of all of PCC’s operating expenses and pay the difference between PCC’s total net revenue and total operating expenses (net operating loss) on an ongoing basis.

5.3 Beginning in Fiscal Year 2020 through the end of Fiscal Year 2026, spend not less than \$72.0 million on CAPEX for the Rhode Island Hospitals only, unless otherwise approved by the Attorney General, which shall be spent according to the following schedule:

- (a) For the period covering Fiscal Year 2020 and the first three quarters of fiscal year 2021, not less than \$12.0 million; and
- (b) For the period between October 1, 2021 and September 30, 2026, not less than \$60 million shall be spent as follows:
 - i. not less than \$10.0 million during each fiscal year;
 - ii. not less than \$24 million in CAPEX shall be spent by September 30, 2023; and
 - iii. not less than \$48 million in CAPEX shall be spent by September 30, 2025.

5.4 No more than \$27 million of PACE financing may be applied against the minimum CAPEX requirement.

6. Escrow/Letters of Credit: Prospect, its parent entities and/or principal shareholders shall fund the following escrow accounts (collectively the “Escrows”) and provide the following irrevocable standby letters of credit (the “Letters of Credit”):

6.1 Interim Escrows. Pursuant to one or more escrow agreements acceptable to the Attorney General, Prospect, its parent entities and/or principal shareholders and Leonard Green shall, prior to Closing of the Proposed Transaction, fund three (3) escrow accounts as follows (collectively the “Interim Escrows”):

- (a) The amount of \$12,000,000, of which Prospect shall fund \$4,000,000 and Leonard Green shall fund \$8,000,000 (“the Global Conditions Escrow”);
- (b) The amount of \$41,000,000 (the “CAPEX Escrow”), of which Prospect shall fund \$14,200,000 and Leonard Green shall fund \$26,800,000;
- (c) The amount of \$27,000,000, funded entirely by Prospect (“MAAP Escrow”);
- (d) The Interim Escrows shall comply with, among other things, the terms set forth in Condition 6.5;
- (e) All funds that Leonard Green is required to provide for the Interim Escrows shall be paid directly by Leonard Green; and

⁴ Pursuant to Section VI of the Decision.

- (f) The Interim Escrows shall remain in place until replaced as set forth in Conditions 6.2 and 6.3, and the Attorney General shall provide written instructions to the escrow agent for the Interim Escrows to release the funds in the Interim Escrows for the purpose of providing the Letters of Credit and or Escrows required by Conditions 6.2 and 6.3.
- (g) In the event a draw or a reduction is required from the Interim Escrows, such draw or reduction shall take place in accordance with the provisions of Conditions 6.4 or 6.5 as applicable.

6.2 Prospect Letters of Credit. Prospect, its parent entities and/or principal shareholders shall, on or before August 15, 2021, provide three (3) irrevocable standby letters of credit (collectively the "Prospect Letters of Credit"), in accordance with and subject to Condition 6.6, as follows:

- (a) A \$4,000,000 letter of credit that shall not expire until the Attorney General has determined that Prospect has complied with all Conditions through September 30, 2026 ("Prospect Global Conditions LOC").
- (b) A \$14,200,000 letter of credit (the "Prospect CAPEX LOC") that shall be reduced in accordance with the CAPEX Escrow/LOC Reduction Schedule set forth in Condition 6.4.
- (c) A \$27,000,000 letter of credit (the "MAAP LOC") that shall not expire until the Attorney General has determined that all of PCC's MAAP Obligations have been satisfied in full. The MAAP LOC shall, among other things, secure Prospect's guaranty of PCC's MAAP Obligations (see Condition 9). The MAAP LOC shall be reduced quarterly, only upon the written determination of the Attorney General, by the amount of the PCC's MAAP obligations that have been satisfied in the preceding quarter.

6.3 Leonard Green Obligations. Leonard Green shall, on or before August 15, 2021, either fund Escrows or provide irrevocable standby Letters of Credit, in accordance with and subject to Conditions 6.5 and 6.6, provided that Leonard Green shall use reasonable commercial efforts to obtain the Letters of Credit as set forth in this Condition 6.3.

- (a) Provide an Escrow or a Letter of Credit in the amount of \$8,000,000 that shall not expire until the Attorney General has determined that Prospect has complied with all Conditions through September 30, 2026 ("LG Global Conditions Escrow/LOC").
- (b) Provide an Escrow or a Letter of Credit in the amount of \$26,800,000 (the "LG CAPEX Escrow/LOC") that shall be reduced in accordance with the CAPEX Escrow/LOC Reduction Schedule set forth in Condition 6.4.

6.4 CAPEX Escrow/LOC Reduction Schedule" shall mean the following reductions in the Prospect CAPEX LOC and the LG CAPEX Escrow/LOC (collectively the "CAPEX Funds") based on the following conditions:

- (a) An \$8 million reduction in the CAPEX Funds, with 40% of the reduction returning to Prospect and 60% of the reduction returning to Leonard Green, on the later to occur of September 30, 2021, or the date upon which all of the following conditions have been satisfied: (a) the Attorney General has determined in writing, based upon documentation provided by Prospect no later than July 30, 2021, that Prospect has spent not less than \$12.0 million in CAPEX for the Rhode Island Hospitals between October 1, 2019, and June 30, 2021, (provided that none of the foregoing CAPEX payments shall be included in the calculation of the minimum CAPEX requirement set forth in Condition 5.3(b)); (b) Prospect has provided Letters of Credit in accordance with Condition 6.2; and (c) Leonard Green has provided Escrows or Letters of Credit in accordance with Condition 6.3.
- (b) A \$6.0 million reduction in the CAPEX Funds upon the written determination by the Attorney General that Prospect has complied with all Conditions through September 30, 2022, with the reduction prorated between Prospect and Leonard Green based on the Reduction Percentages.
- (c) A \$7.0 million reduction in the CAPEX Funds upon the written determination by the Attorney General that Prospect has complied with all Conditions through September 30, 2023, with the

reduction prorated between Prospect and Leonard Green based on the Reduction Percentages.

- (d) A \$7.0 million reduction in the CAPEX Funds upon the written determination by the Attorney General that Prospect has complied with all Conditions through September 30, 2024, with the reduction prorated between Prospect and Leonard Green based on the Reduction Percentages.
- (e) A \$7.0 million reduction in the CAPEX Funds upon the written determination by the Attorney General that Prospect has complied with all Conditions through September 30, 2025, with the reduction prorated between Prospect and Leonard Green based on the Reduction Percentages.
- (f) A \$6.0 million reduction in the CAPEX Funds upon the written determination by the Attorney General that Prospect has complied with all Conditions through September 30, 2026, with the reduction prorated between Prospect and Leonard Green based on the Reduction Percentages.
- (g) If Prospect fails to comply with a mandated condition in a given fiscal year, the scheduled reduction for that fiscal year shall not occur until the Attorney General has determined in writing that Prospect has remedied the failure.
- (h) The term "Reduction Percentages" shall mean 66.67% to the LG CAPEX Escrow/LOC and 33.3% to the Prospect CAPEX LOC.

6.5 The following terms, among others, shall apply to the Escrows:

- (a) The Escrows shall not be funded by PCC's revenue, funded by a loan secured by PCC's assets, or collateralized by PCC's assets;
- (b) The funds in the Escrows shall, at the written direction of the Attorney General, be distributed to the Agent/Trustee, if, as determined by the Attorney General (i) Prospect fails to comply with its obligations under II. Financial Conditions (Conditions 5-11) or Condition 22 (Continuity of Services), and/or (ii) an Insolvency Event occurs;
- (c) The Attorney General shall provide written instructions, in accordance with these Conditions, to the escrow agent regarding the distribution of funds from the Escrows;
- (d) The Escrows shall not be reflected as a liability of PCC or the Hospitals on their financials;
- (e) The Escrows, with the exception of the Interim Escrows set forth in Condition 6.1, shall be (i) with an entity that conducts business in the State of Rhode Island, (ii) be subject to Rhode Island law, and (iii) be subject to an agreement that provides, among other things, for disputes to be resolved in the courts of Rhode Island;
- (f) The agreements governing the Escrows shall be approved by the Attorney General; and
- (g) The escrow agent shall be approved by the Attorney General.

6.6 The following terms, among others, shall apply to the Letters of Credit:

- (a) The Letters of Credit shall not be funded by PCC's revenue, funded by a loan secured by PCC's assets, or collateralized by PCC's assets;
- (b) The Letters of Credit shall list the Agent/Trustee as the beneficiary;
- (c) The Letters of Credit shall be irrevocable standby letters of credit in a form acceptable to the Attorney General;
- (d) The Letters of Credit may be drawn upon by the Agent/Trustee, at the written direction of the Attorney General, if, as determined by the Attorney General: (i) Prospect fails to comply with its obligations under II. Financial Conditions (Conditions 5-11) or Condition 22 (Continuity of Services) and or (ii) an Insolvency Event occurs;
- (e) The Attorney General shall provide written instructions, in accordance with these Conditions, to the financial institution issuing the Letters of Credit regarding the reduction in the Letters of Credit;
- (f) The Letters of Credit shall not be reflected as a liability of PCC or the Hospitals on their financials;

- (g) The Letters of Credit shall be (i) with an entity that conducts business in the State of Rhode Island, (ii) be subject to Rhode Island law, and (iii) be subject to an agreement that provides, among other things, for disputes to be resolved in the courts of Rhode Island;
- (h) The agreements governing the Letters of Credit shall be approved by the Attorney General; and
- (i) The Letters of Credit shall be issued by one or more financial institutions approved by the Attorney General.

6.7 Reduction determinations with respect to the CAPEX Escrows and the Letters of Credit, as applicable, will be made by the Attorney General within thirty (30) days after documentation provided by Prospect to support a reduction is deemed complete by the Attorney General, such completeness determination not to be unreasonably withheld.

6.8 (a) If the Attorney General determines in writing, as provided in Condition 6.7, that Prospect has failed to comply with any of the required Conditions at any time in a given fiscal year, the Attorney General shall provide Prospect with written notice specifying in reasonable detail the Condition(s) that the Attorney General has determined has not been satisfied and the reasons therefor, and Prospect shall have thirty business days to cure any and all deficiencies with respect to such specified Condition(s). If Prospect has cured any and all deficiencies with respect to such Condition(s) within thirty (30) days of such written notice, the Attorney General shall make the scheduled reduction determination as provided in Condition 6.7.

(b) The Attorney General shall notify Prospect ten (10) days prior to any draw of the Escrows or Letters of Credit pursuant to Conditions 6.5(b) or 6.6(d), respectively, such notification to specify in reasonable detail the Condition(s) that the Attorney General has determined has not been satisfied and the reasons therefor, unless exigent circumstances exist, including but not limited to significant service disruptions or imminent closure of either of the Rhode Island Hospitals which require an immediate draw, in which case the Attorney General shall so inform Prospect, and may proceed with the draw within two (2) business days.

6.9 Prospect and Leonard Green shall pay all fees and costs associated with the Escrows and Letters of Credit.

6.10 Agent/Trustee Agreement. Any of the funds from the Escrows and/or the Letters of Credit that are delivered to the Agent/Trustee shall be governed by the Agent/Trustee Agreement. Prospect and Leonard Green shall execute the Agent/Trustee Agreement within five (5) business days of its approval by the Attorney General.