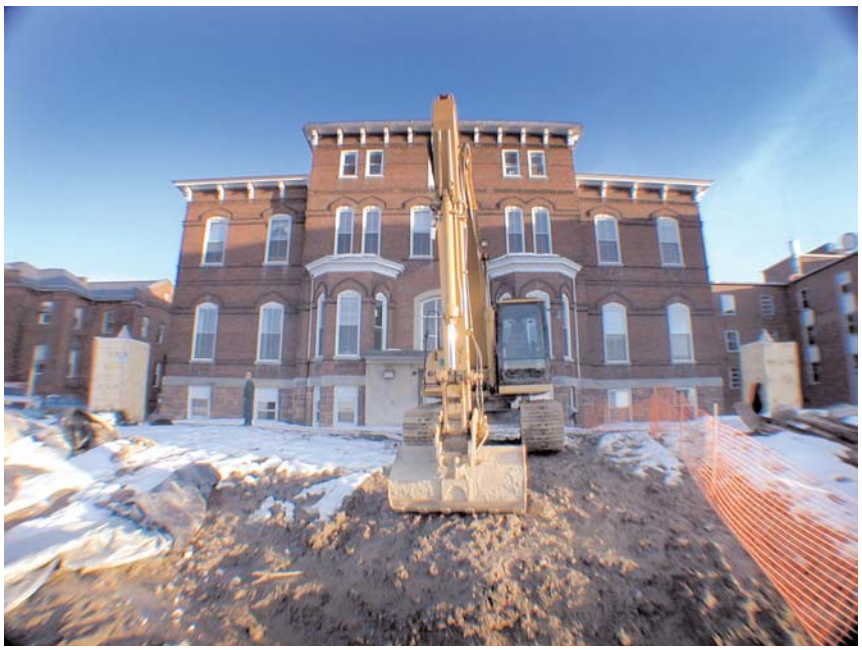
Program Assessment

Office of the State Auditor

Rebuilding Public Trust



Recommendations to Strengthen the State's Oversight
of the Use of Tax-Exempt Bond Proceeds
to Build Health Care Facilities

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Vermont State Auditor

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Mission Statement

The mission of the State Auditor's Office is to be a catalyst for good government by promoting reliable and accurate financial reporting as well as promoting economy, efficiency and effectiveness in State government.

Office of the State Auditor

Assessment of the Internal Controls related to the Financing Agreement between the Vermont Educational and Health Buildings Financing Agency and Fletcher Allen Health Care

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Cover Photo: Matthew Thorsen

Message from the Auditor

This report – *Rebuilding Public Trust* – offers simple steps to protect the State's health care consumers from rising costs due to poor oversight of major construction projects paid for with tax-exempt bonds.

The management and board of Fletcher Allen Health Care (FAHC) in Burlington certainly understood the old adage, "if we build it, they will come." When Vermont consumers do finally come through the doors of the hospital when the Renaissance Project is complete, they will come, in large part, with public tax dollars – through Medicare and Medicaid, as well as taxpayer-funded health plans provided to teachers and municipal, state and federal workers.

> *Vermont took the laissez-faire attitude that FAHC would be responsive and responsible for the Renaissance Project. They relaxed their guard. They were wrong to do so.*

FAHC has rightfully been on the firing line for the atmosphere of deceit, concealment and mismanagement that led to a tripling of construction costs on the Renaissance Project. Congressman Bernie Sanders and Governor Jim Douglas have properly pushed for a new climate of accountability at the state's largest hospital.

Our Office's review of some of the spending associated with this project points to the heart of the matter: No one was watching. Not at FAHC, and not at the State.

Our top recommendation is that the State agency that issues tax-exempt bonds must use its statutory authority to ensure that proper project management and audit and compliance functions are in place before it issues tax-exempt bonds. If it had in the case of FAHC, perhaps millions of dollars in questionable spending could have been caught earlier.

For example, on August 19, 2002 our Office raised a concern that FAHC appeared to have used more than a million dollars in tax-exempt bonds to build its private parking garage. In December 2002 FAHC announced that it had reallocated - to date - $1,032,102.70 of bond proceeds that had been improperly spent on the garage in direct violation of their financing agreements with the State.

Then, the private accounting firm PricewaterhouseCoopers, hired by FAHC to examine its oversight of the Renaissance Project, also found that FAHC had to reallocate several million dollars in capital items that were categorized as operating expenses.

Finally, our Office observed that FAHC approved expenses from its out-of-state construction manager that, while legal, may have not been prudent. Tens of thousands of dollars a month were apparently reimbursed with tax-exempt bond proceeds for meals, fleece jackets and vests, hats, coffee mugs, hotel rooms, car rentals, airfare, relocation expenses and even the cost of attending a FAHC-sponsored golf tournament.

The allocation and spending problems, along with cost overruns, shows a telltale lack of independent oversight on behalf of FAHC. But the State is also to blame for failing to fully understand its stake in the project. It is the tone set by State government that either demands, or downplays, the need for diligence, accountability and transparency in controlling construction costs that ultimately are paid by Vermont health care consumers. Unfortunately, there was no culture of accountability, the State agencies didn't communicate, and problems went unnoticed for almost a full year. Now ordinary people will pay the price.

My Office examined the process by which large health care construction projects are approved, financed and overseen by State entities. We studied the little-known State agency called the Vermont Educational and Health Buildings Financing Agency (the Agency), which since 1966 has issued tax-exempt bonds to the investment community on behalf of Vermont's non-profit educational and health care institutions. The Agency is a small, understaffed agency with an unpaid Board of Directors that has worked hard since its inception to become a vehicle for the state's non-profit hospitals to secure low-interest, tax-exempt financing for their construction projects.

We looked carefully at how the Agency issued and reviewed the $150 million in bonds issued on behalf of FAHC. The result of this review is a four-point plan to improve the oversight of tax-exempt bond spending, and to help ensure that future hospital construction projects do not place Vermonters, bond investors and the State at risk by misconduct and deception.

Aside from more proper oversight, we recommend that the State agency that issues tax-exempt bonds and the State agency that regulates health care spending must create a seamless new culture of due diligence and accountability through improved communication and oversight. If FAHC's periodic requests to the Agency to draw down bond funds had been seen by regulators just down the street in Montpelier at the Department of Banking, Insurance, Securities and Health Care Administration (BISHCA), the hospital's spending problems could have been noticed much sooner – as early as August of 2001.

We observed that:

- The Agency executes little due diligence or oversight of the use of bond proceeds when making formal financing arrangements and disbursing funds. In the case of FAHC, the Agency did not require high standards of project management or that proper audit and compliance functions were in place;

- The Agency released at least $50 million in tax-exempt bond proceeds without proof, as required by law, that FAHC had a Certificate of Need; and,

- The Agency did not require proper segregation of bond spending, allowing more than $1 million to be spent on a private parking garage in direct violation of bond financing agreements.

We recommend the Agency should:

- Require higher standards of project management and cost containment at the borrowing institution to ensure that a project is staying within budget and that problems are quickly and properly scrutinized;

- Strengthen systems for monitoring and reviewing bond disbursements;

- Require an independent, forensic audit of FAHC's spending of tax-exempt bond proceeds to reveal if any questionable costs were repaid with these proceeds; and,

- Improve communications with BISHCA and put in place a seamless review and approval process for health construction financing.

Vermonters spend more money each year on health care, with hospital gross revenues approaching $1.5 billion annually in Vermont.[1]

FAHC reported approximately $760 in gross revenues – or nearly half of all hospital gross revenues bill in the state for Fiscal Year 2002, according to State regulators. Hospital officials say they collected $505 million in net revenues based on these gross charges. About $268 million of gross revenue was attributable to taxpayers through Medicare and Medicaid payments. In short, hospital spending affects everyone.

Vermont agencies took the laissez-faire attitude that FAHC would be responsive and responsible for the Renaissance Project, one of the single-most expensive building projects in the State's history. They relaxed their guard. They were wrong to do so.

FAHC's current management team, led by interim Chief Operating Officer Edwin I. Colodny, has admitted that the hospital purposely hid more than $81.3 million associated with the Renaissance Project from State regulators. Colodny has pledged to rebuild the hospital's relationship with the State, offering an opportunity for Vermont to improve its overall system of oversight.

With a new Administration and an attentive Legislature, the State of Vermont must use this opportunity to bolster the public's confidence and develop a much-needed culture of accountability – based on diligence, not bureaucracy – that will assure Vermonters their interests are being protected.

Sincerely,

Elizabeth M. Ready

Elizabeth M. Ready
State Auditor
March 14, 2003

[1] Revenue figures are from "Vermont Community Hospitals Financial and Statistical Profiles," published by BISHCA, August 2002.

Introduction

Vermonters will spend more than $2 billion on health care in 2003, with at least $300 million coming from taxpayers through Medicaid and Medicare. This does not include the taxpayer-funded health plans of municipal, state and federal workers – as well as teachers.

FAHC will bill patients for more than $700 million of these charges, and receive about $500 million in net revenues. Simply put, what happens at FAHC has a large impact on health care costs throughout Vermont.

The rising cost of health care is driving budget increases of every Vermont family, business, school and town; it is the single greatest cost driving state and federal budget increases, too.

That's why all Vermonters should be concerned that FAHC's construction project, known as the Renaissance Project, has ballooned in cost from an initial $118 million to $326 million, according to a November 8, 2002 letter from FAHC's interim CEO Edwin Colodny to state regulators. That number may now be even higher, according to report issued January 31, 2003 by the architectural firm NBBJ of Seattle, Washington, which was hired by BISHCA to examine the project. In its report, NBBJ said FAHC devoted a more than typical amount of space to circulation and infrastructure adding an estimated "$16 to $21 Million premium to the project," while the quality of the building is "now known to be higher than comparable facilities, adding upwards of $30 million in costs."[2]

Our Office examined elements of the process by which large health care construction projects are approved, financed and overseen by State entities.

[2] Fletcher Allen Health Care Renaissance Project Review, NBBJ, January 2003, p. 5.

In this report we offer recommendations to improve internal controls over how tax-exempt bond spending is reviewed and approved for these projects. We also offer ways to improve how State agencies communicate about the review and financing of these large projects. While FAHC may not be a public entity, every dollar it misspends has the effect of driving up the public and private costs of health care. Improved oversight of tax-exempt bond proceeds issued by the Agency could be a tool to help keep construction costs under control, and help lower the cost of health care for citizens and businesses.

It is important to note that the Agency is a small entity with a commendable track record. Since its inception in 1966 it has served as a successful vehicle for the state's non-profit hospitals and colleges to secure access to low-interest, tax-exempt financing for their construction projects.

In addition to offering market access to low interest rates, the Agency must conduct proper diligence in overseeing the requisition and disbursement of tax-exempt bond proceeds.

The primary responsibility for regulating financial aspects of health care institutions lies with BISHCA. However, the Agency is the control point for the flow of millions of dollars in tax-exempt bonds to institutions such as FAHC that have important public, non-profit missions. The Agency has an opportunity to use its existing statutory authority to strengthen its controls over how institutions use tax-exempt bond proceeds, and improve communication with BISHCA and other state agencies.

FAHC's executive, and Board of Trustees', management failures were illustrated in the Fletcher Allen Ad Hoc Committee Report's analysis of the oversight the Renaissance Project.[3] State government, too, has an important role to play in providing a system of checks and balances to rogue institutions, such as FAHC, that are recipients of public funds.

[3] *Report of the Ad Hoc Committee Concerning Governance and Compliance Issues Relating to the Renaissance Project*, Fletcher Allen Ad Hoc Committee, November 15, 2002.

Background

A quasi-state entity, the Vermont Educational and Health Buildings Financing Agency was established in 1966[4] to be the statewide issuer of tax-exempt municipal bonds for non-profit educational and health care institutions. The Agency provides these institutions with access to the tax-exempt capital markets with its lower interest rates and provides bond buyers with non-taxable income on the interest earned throughout the life of the bonds. Low, non-taxable interest on these bonds also helps institutions keep the overall cost of construction costs lower because the income generated from the interest on these bonds is not taxable income.

The Agency's duties and powers are described at length in Statute.[5] The Office of the State Auditor has explicit authority to "at any time examine the accounts and books of the agency including its receipts, disbursements, contracts, sinking funds, investments and any other matters relating to its financial standing."[6]

As of December 31, 2001, the Agency had issued 101 series of bonds, including bond refundings, totaling $1.071 billion. It has about $700 million outstanding.[7]

The bonds issued by the Agency are not a debt of the State, and the Agency's role is to provide access to the capital markets. However, many observers believe that the overall financial reputation of the State could be affected if serious problems are found as a result of the various investigations circling FAHC.

The Agency's Board of Directors is comprised of seven members appointed by the Governor, two by the members appointed by the Governor and four ex-officio members (the Secretary of the Agency of Human Services, the Secretary of the Agency of Administration, the Commissioner of the Department of Education and the State Treasurer).

[4] 16 VSA Chapter 131, §§ 3851 – 3862.
[5] 16 VSA Chapter 131, §§ 3851 – 3862.
[6] 16 VSA Chapter 131, § 3855(c).
[7] Vermont Educational and Health Buildings Financing Agency's 2001 Annual Report.

Current federal tax laws allow the Agency, on behalf of any eligible institution, to issue bonds or notes for eligible projects on a tax-exempt basis. The Agency, in turn, loans the proceeds to the borrowing institution. The Agency has no taxing power. Bonds and notes of the Agency issued for a specific institution are repaid solely from funds generated by the borrowing institution and are secured entirely with collateral provided by the borrower or through additional credit backing, such as bond insurance or letters of credit from commercial banks.

By state law, the Agency is only allowed to finance the construction of buildings and purchase of related equipment specific to the project described to financiers and potential bondholders. The Agency cannot fund what is known as “working capital” or routine capital expenses that an institution must replace or upgrade on a periodic basis as part of doing business.[8] Federal income tax law allows the financing of working capital under certain circumstances and does not distinguish between routine capital expenditures and expenditures for specified projects.[9]

Eligible health care institutions include any non-profit hospital; any non-profit institution whose purpose is devoted primarily to the maintenance and operation of diagnostic and therapeutic facilities for medical, surgical or psychiatric care of ambulatory patients; any non-profit licensed nursing home; any non-profit assisted living facility, non-profit continuing care retirement facility, non-profit residential care facility or similar non-profit facility for the continuing care of the elderly or the infirm. These eligible facilities must be owned by or under common ownership with an otherwise eligible institution. And, certain health care facilities must also, if required, have a Certificate of Need (CON) issued by BISHCA to be eligible.

CON reviews, and the public hearings held by the Public Oversight Commission, conducted prior to the issuance of a CON are designed to closely examine major capital investments to determine their financial impact on Vermont’s health care system.

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[8] Discussions with Agency Executive Director and SAO staff, August – September 2002.

[9] Letter from Agency Executive Director Malcolm S. Rode to State Auditor Elizabeth M. Ready, February 27, 2003, p. 2.

On March 17, 1999 FAHC began discussions with the Agency to design a bond issuance to support the construction of what is now referred to as the Renaissance Project. A month later, on April 12, 1999, FAHC received a CON from BISHCA for the project. The working group established by the Agency and FAHC drafted the pricing structure of the bonds, loan agreements and other bond financing documents. The working group consisted of members of FAHC, the Agency, their lawyers, bond analysts, underwriters, financial advisors and others. The group then presented the project and bond sale to the Agency's board for approval.

On August 27, 1999 the Agency's Board of Directors, according to Board minutes of the meeting, voted unanimously to authorize the "issuance and sale of not to exceed $275,000,000 aggregate principal amount of Vermont Educational and Health Buildings Financing Agency Hospital Revenue and Refunding Bonds …" on behalf of FAHC.

On September 21, 1999, nearly a month after the Agency's Board approved the issuances, the Agency held a public hearing related to its approval of the bond issuance on FAHC's behalf. No one from the public attended and the meeting lasted 30 minutes, according to the meeting's minutes.

On March 29, 2000 Salomon Smith Barney, FAHC's bond underwriter, sold the Agency's bonds on the open market, including the $100 million (2000A Series) and the $50 million (2000B series). The bonds were to be used to fund the construction of the Renaissance Project, and pay certain other capital costs. In addition, FAHC noted it had an interest in refunding older debt with these bond proceeds due to favorable interest rates at the time of pricing.

In the Official Statement that accompanied the bond sale, and in other bond financing documents, the project to be financed by the sale was described as follows to potential bond purchasers:

> " … for paying a portion of the costs of the acquisition, construction and equipping of (a) new ambulatory care facility consisting of multi-purpose clinical modules and an outpatient surgical center and day hospital, (b) a new core laboratory within the proposed ambulatory care facility, (c) a new cancer center to provide space for treatment, teaching and clinical research, (d) a new education center consisting of teaching laboratories, simulation rooms, offices, a conference center and an audi-

> torium, (e) a new five-tier parking structure, (f) a patient access center providing access to inpatient, outpatient, educational and research facilities, all on the Corporation’s MCHV Campus (the “MCHV Campus”) located in Burlington, Vermont (items (a) through (f) are collectively referred to herein as the “Ambulatory Care Facility Project”), (g) renovations of existing space on the MCHV Campus, (h) renovations of facilities on the Corporation’s Fanny Allen Campus located in Colchester, Vermont for use as a rehabilitation center, and (i) routine capital improvements and equipment, including capital improvements and equipment which have been completed or acquired, for various health facilities and clinical programs operated by the Corporation (collectively, the “Project”).

Upon the sale of the bonds, Salomon Smith Barney received $750,000 ($650,000 for Series A and $100,000 for Series B). The remaining issuance costs for both bonds totaled $816,050.85 and paid for bond rating services, lawyers and other financial advisors, according to bond financing agreements on file with the Agency.

With the Series A proceeds, FAHC reimbursed itself for $2.5 million for “Network/PC Rollout (computers)” and then deposited $65,010.952.19 in a Construction Fund. An additional $10 million was deposited in a Reserve Account and nearly $20 million was deposited in an Interest Account, according to documents on file with the Agency.

With the Series B proceeds, FAHC set aside $45,663,615.59 in the Construction Fund. It then reimbursed itself for $27.5 million for various capital expenditures it had incurred prior to the issuance of the bonds. This included $6.8 million for the rehabilitation project at FAHC’s Fanny Allen Campus in Colchester, and nearly $2 million to purchase a building and land at 35 Joy Drive in South Burlington. Additional funds were used to repay the cost of a new MRI, and a number of telecommunications and computer software and hardware upgrades. FAHC also deposited an additional $3.2 million in an Interest Account. This left slightly more than $19 million in a Construction Fund, according to documents on file with the Agency.

Observations & Recommendations

Observation 1

The Agency executes little due diligence or oversight of the use of bond proceeds. Instead, the Agency relies solely on the assurances of borrowers when making formal financing arrangements and disbursing funds.

In the case of Fletcher Allen Health Care, the Agency did not require high standards of project management or that proper audit and compliance functions were in place before it agreed to issue tax-exempt bonds.

Discussion

Public financing authorities, like the Agency, rely on the rules of the private capital markets to guide their activities. They accept the borrower's representations prior to approval, and while the bonds are being repaid. They generally accept, without questions, the borrower's request for money to be disbursed from the Construction Fund.

This system works well as long as the borrower's governing board has an expert team in place to manage construction costs and maintain proper oversight of the use of bond proceeds. According to the *Report of the Ad Hoc Committee Concerning Governance and Compliance Issues Relating to the Renaissance Project*, Fletcher Allen did not have this necessary structure in place to carry out these oversight duties. The report described FAHC's management as having a "culture of withholding information" from State agencies as well as its own Board of Trustees.

Given the large sums of public funding at stake, recent efforts to improve governance, increase public representation on the Board and to have the Board hold its meetings subject to Vermont's Open Meeting Law could create an atmosphere where improved oversight of bond proceeds and construction management would be a high priority.

Aside from these future steps, the Agency currently has broad authority in Statute to require that construction projects financed with tax-exempt bond proceeds put in place strong construction management teams. Statutory language reads, in part:

> "The trust indenture or resolution authorizing the bonds may contain reasonable provisions for protecting and enforcing the rights and remedies of the bondholders, including covenants setting forth the duties of the agency in relation to the acquisition, construction, maintenance, operation, repair and insurance of the facilities and the custody, safeguarding and application of all moneys, and may provide that any facility shall be constructed and paid for under the supervision and approval of consulting engineers or architects."[10]

Strengthening Bond Oversight

Increasingly, taxpayers are requiring greater accountability over the use of tax-exempt bond proceeds. Bond Oversight Committees are utilized in several states to ensure that major construction projects funded with tax-exempt bond proceeds stay on budget. These committees make the public aware of any major changes in the project's scope, and they report findings to the public and the proper regulatory authorities.

For example, the District Twenty school district in Colorado Springs, Colorado, created a Bond Expenditure Oversight Committee to oversee a $163 million construction and renovation project. The committee was established to:

- Provide periodic review of projects and their status;
- Report on the status of projects to the Superintendent for the Board of Education;
- Review proposed changes in the scope of a project and making recommendations relative to such changes through the Superintendent to the Board of Education; and,
- Provide periodic input on information provided to the community on the status of the Bond Program.

[10] VSA 16 Chapter 131, §3856(h)

The District Twenty's Bond Oversight Committee does not review each invoice, but it does look at summaries provided by the project manager.[11]

A red-yellow-green light system has been instituted by the Project Manager to evaluate the severity of any given situation.[12] The lights indicate the following:

- A green light indicates that the committee only needs to glance at the project summary;
- A yellow light indicates that they should give it more scrutiny (because the project is behind schedule or over budget); and,
- A red light indicates that scrutiny must be given to the project. Continued red lights on a specific project would necessitate a look at invoices.

If a spending guideline - set by Federal and Colorado State law - is violated, the Bond Oversight Committee is primarily in a "recommending position." The committee reports the violation to the superintendent who will go to the Board who will then report the violation to the proper Federal or State authority.[13]

The Role of An Audit Committee

In lieu of a Bond Oversight Committee, the Agency could ensure borrowers have in place other strong review and compliance functions before agreeing to issue tax-exempt bonds. FAHC's Ad Hoc Committee recommended one such option in its November 12, 2002 report. This option would not require an additional oversight by an outside entity, and it would strengthen the internal controls and policies of the hospital.

Specifically, the Ad Hoc Committee recommended that FAHC strengthen its internal controls by broadening the scope of its compliance function. The reports states:

> "The information gathered makes clear that Fletcher Allen's compliance function, although substantial, is directed almost exclusively toward cost reimbursement issues. As a result, the documentation and implementation of the compliance function must be broadened to include BISHCA matters, and other areas of sig-

[11] Jim Stamper, Chief for Administrative Support and Services at District Twenty, in a telephone interview with SAO staff on December 10, 2002.

[12] Ibid.

[13] Ibid.

> nificant compliance risk. For example, the Compliance Plan should be revised to specifically address BISHCA-related compliance matters, including a description of BISHCA requirements. In addition, CON-approved projects should be reviewed, when completed, to assure compliance with CON conditions. Compliance training and orientation programs should also focus on BISHCA, and should target, among others, the finance and facilities development areas. The Compliance Team should also assure that its audit function extends to BISHCA-related matters."[14]

The report also notes that compliance issues did not arise until people within various departments discussed it, rather than having an audit and compliance plan in place before a project is started. "For this reason, there should be closer compliance-related coordination among the areas of Planning & Business Development (& Government Relations), Finance, Facilities Development, General Counsel and Compliance, to address CON issues," the report states.[15]

Public and private institutions benefit from a strong internal audit or compliance division that reports directly to an active Audit Committee of the entity's governing board, rather than reporting directly to the managers of the projects they audit or review. Compliance reviews, or internal audits, at early stages of a given project can ensure that it stays on an appropriate construction schedule and meets all state and local permits and regulations, and bond or loan financing agreements. This avoids possible delays at future dates, or incurring costs that may not meet various permits and regulations.

An Audit Committee could assume the role of a Bond Oversight Committee outlined above, or it could empanel a committee of experts to analyze contracts, establish spending controls and review the use of tax-exempt funds.

Such a strong internal compliance review in the case of the Renaissance Project may have revealed questionable spending and cost overruns at an earlier date. These issues could have been raised directly to the Audit Committee of the Board of Trustees, and, in turn, State health care regulators and the Agency.

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[14] *Report of the Ad Hoc Committee Concerning Governance and Compliance Issues Relating to the Renaissance Project*, Fletcher Allen Ad Hoc Committee, November 15, 2002, pgs 69-70.

[15] Ibid, p. 71.

Bond Financing Disclosure Terms

It is difficult to determine whether many of the capital items listed in this report (*Observation 3, pages 36-40*) were fully paid for with tax-exempt bond proceeds. It appears that some, or all, of the costs did not have the appropriate CON and the expenses were improperly, and knowingly paid for by FAHC with tax-exempt bond funds. If this is the case, FAHC has an obligation under its financing agreements to notify the Agency and the Chittenden Bank of these violations.

Public and private institutions benefit from a strong internal audit or compliance division that reports directly to an active Audit Committee of the entity's governing board, rather than reporting to the managers of the projects they review.

When it signed its bond financing agreements, FAHC agreed to the following:

> "The Agency and Hospital severally covenant that they will, at the expense of the Hospital, promptly give to the Bond Trustee written notice of any Event of Default under this agreement of which they shall have actual knowledge or written notice, but the Agency shall not be liable for failing to give such notice."[16]

An "Event of Default" is a broad term that includes:

> "default in the due and punctual performance of any other of the covenants, conditions, agreements and provisions contained in this Trust Agreement or any agreement supplemental hereto and thereto and such default shall continue for thirty (30) days or such further time as may be granted in writing by the Bond Trustee after receipt by the Agency of a written notice from the Bond Trustee specifying such default and requiring the same to be remedied …"[17]

[16] Article VI, Section 6.06, Loan Agreement between FAHC and the Agency, February 1, 2000.

[17] Article VIII, Section 801(c), Trust Agreement between the Agency and Chittenden Trust Company, dated February 1, 2000.

In its financing agreements, FAHC agrees to file a certificate of no default with the Agency, Ambac Assurance and the Chittenden Bank (or any bondholder who holds at least 25 percent of the bonds) upon their request.[19]

To date, no such request has been made. However, according to an August 23, 2002 letter from the Agency to the State Auditor:

> " … the Agency's financing documents require the borrowers to certify annually as to the absence of covenant defaults (or, if such defaults exist, what remedial action is being taken). Compliance with covenants, however, always remains the responsibility of the borrower."[19]

The Agency's Bond Counsel, in a letter to the Agency's Executive Director, concurs with the Auditor's observation that FAHC has failed to file these officer's certificates on an annual basis. Bond Counsel states:

> "We have, at your request, discussed Section 3.10(b) with Fletcher Allen and its counsel and have been informed that the annual officer's certificates required to be filed have not in fact been filed, either with the Master Trustee or, pursuant to Sections 5.04 of each of the Loan Agreements related to the Bonds, with the Agency, Ambac Assurance or the Bond Trustee (which is the same entity as the Master Trustee)."[20]

The Agency's Bond Counsel then adds:

> "Failure to file the required certifications raises two issues – the first procedural and the second substantive. The procedural issue relates to the failure to file the certificate itself which, once such failure occurs, constitutes a covenant default. The substantive issue relates to what the certification would have said about covenant defaults had it been timely filed."[21]

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[18] Section 5.04 of the Loan Agreement between FAHC and the Agency dated March 1, 2000, and Section 3.10(b) of the Master Trust Indenture dated March 1, 2000.

[19] Letter from Malcolm Rode, the Agency's Executive Director, to State Auditor Elizabeth M. Ready, August 23, 2002, p. 5.

[20] Letter from Max Von Hollweg, Agency Bond Counsel, to Agency Executive Director Malcolm S. Rode, February 27, 2003, p. 2.

[21] Ibid, pgs 2-3.

FAHC told the Agency and Bond Counsel that it did file, on February 24, 2003, the required officer's certificate pursuant to the bond financing agreements. FAHC also filed a supplemental officer's certificate for Fiscal Year 2001. These documents certify that FAHC is "not in default in the performance of its covenants under the bond documents and that there are no defaults from earlier years that remain uncured, with the exception of the timely filing of the officer's certificates, which of course cannot be corrected."[22]

Bond Counsel believes the February 24, 2003 certificate is responsive to the formal requirements of the Master Trust Indenture, only that it was filed later than the required date of January 31.[23]

In lieu of the self-reporting function of the bond financing documents as it relates to officer's certificates and notification of covenant defaults, the Agency can bill for services associated with the independent verification of FAHC claims. FAHC agreed, for example, in its bond financing documents, to pay:

> "reasonable fees and other costs that the Hospital are obligated to pay, not otherwise paid under this Agreement or the Trust Agreement, incurred by the Agency in connection with its administration and enforcement of, and compliance with, this Agreement or the Trust Agreement …"[24]

Eligible Costs: Legal, but were they prudent?

Bond financing agreements routinely provide general guidance on what comprises an eligible cost of tax-exempt proceeds as it relates to the approved project.

The Agency notes that federal income tax regulations permit it to reallocate bond proceeds away from the garage for federal tax purposes, if necessary, within 18 months after a project is place in service. This could still happen, as long as such an allocations is made within five years after the issue date.[25]

[22] Letter from Spencer R. Knapp, FAHC's Acting General Counsel, to Agency Executive Director Malcolm S. Rode, February 27, 2003, p. 2.

[23] Ibid, p. 3.

[24] Article III, Section 3.04(b)(iv) of the Loan Agreement between FAHC and the Agency, February 1, 2000.

[25] Letter from Agency Executive Director Malcolm S. Rode to State Auditor Elizabeth M. Ready, February 27, 2003, p. 3.

The Trust Agreement between the Agency and the Chittenden Trust Company, under the heading "Costs of Project," sets out in broad terms what items are eligible for reimbursement with tax-exempt bond proceeds. It states:

> "For the purpose of this Trust Agreement the Cost of the Project shall embrace such costs as are eligible within the purview of the Act and, without intending thereby to limit or restrict any proper definition of such Cost, shall include the following:
>
> (a) obligations incurred by the Hospital for labor, materials and services provided by contractors, builders and others in connection with the acquisition, construction or equipping of the Project, machinery and equipment, necessary water and sewer lines and connections, utilities and landscaping, the restoration or relocation of any property damaged or destroyed in connection with such construction, the removal or relocation of any structures, and the clearing of lands;"[26]

This section further states that eligible costs include:

> "… fees and expenses of engineers and architects for preparing plans and specifications and supervising construction as well as for the performance of all other duties of engineers and architects set forth herein in relation to the acquisition, construction and equipping of the Project …"[27]

In-town and out-of-town travel, meals reimbursements, entertainment charges, automobile rentals and housing expenses for employees of Macomber/Barton Malow have been paid for with tax-exempt bond proceeds throughout the life of the construction project, according to supporting documents reviewed by our Office. This is in addition to construction costs and hourly reimbursement rates for managers that would be expected to be included in such costs.

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26 "Costs of Project," Article IV Section 403 of the Trust Agreement between the Agency and the Chittenden Trust Company, March 29, 2000.

27 Ibid.

Some of these expenses are likely to qualify for reimbursement as legitimate management costs related to the Renaissance Project. However, the monthly high dollar amount raises questions about the contract management policies and procedures in place at FAHC.

For example, in the supporting documents provided by Macomber/Barton Malow for Invoice 72400 (dated February 26, 2002), the “Construction Phase Expenses” for January 16, 2002 to February 15, 2002 include the following charges totaling $15,333.79:

- Internet Connection: $1,353.38
- Cell Phones: $515.15
- In Town Travel: $1,849.11
- Out of Town Travel: $8,356.45
- Relocation Expense: $1,500.00
- Auto: $1,187.72
- Business Meals/Entertainment: $571.98

Similar expenses were charged in following months. In the supporting documents provided by Macomber/Barton Malow for Invoice 73566 (dated April 30, 2002), the “Construction Phase Expenses” for March 16, 2002 to April 15, 2002 include the following charges totaling $58,537.64:

- Internet Connection/Phones: $1,674.22
- Cell Phones/Temp Telephones: $11,558.30
- Out of Town Travel: $9,147.15
- Relocation Expense: $33,377.11
- Auto: $2,221.46
- Business Meals/Entertainment: $559.40

Our Office also observed a $2,500 donation to a Fletcher Allen-sponsored golf tournament and more than $7,000 in mugs, vests and fleece jackets billed by construction managers to the hospital which, in turn, apparently paid for these charges with tax-exempt bond proceeds.

Our Office also noted that construction managers rented rooms at the nearby Sheraton Hotel and Conference Center for a wide range of nightly rates – from around $75 to $155, which were reimbursed by FAHC using bond proceeds. It would appear that negotiating for one, flat rate would save on contract management costs during the life of the project.

Certain fees and expenses are allowable under IRS rules, as well as the Trust Agreement stated above, but in the supporting documentation reviewed by our Office there is little correspondence between FAHC and Macomber/Barton Malow that details how expenses should be charged – either as they relate to the construction contract or the tax-exempt bond proceeds.

At District Twenty in Colorado Springs, Colorado, meals and other various "overhead expenses" are not allowable expenses. The District Twenty Office pays for any beverages or food out of office funds and not from tax-exempt bond proceeds.[28]

Vermont's Legislature biennally approves a Capital Budget to fund a variety of projects throughout Vermont, both to improve and upgrade State-owned facilities and to help pay for local public projects such as highway garages or libraries. Items included in the State's capital budget are governed, in part by Statute, which do place some restrictions on the use of this capital debt, as follows:

> "Activities proposed for funding by general obligation debt financing shall be restricted to tangible capital investments, but may include the planning, design and engineering directly associated with a tangible capital investment."[29]

FAHC's Audit Committee retained PricewaterhouseCoopers (PwC) in September 2002 to investigate certain issues related to the Renaissance Project, including the accounting for expenditures. Two of their observations are relevant here:

> "• Project-related responsibilities have been compartmentalized within separate functional areas resulting in a lack of coordinated decision making;"

> and,

[28] Will Hatcher, District Twenty's Financial Officer, in an interview with SAO staff, December 11, 2002.
[29] 32 VSA § 309(a)(1).

"• The capital budgeting and monitoring process is not linked to a regulatory compliance function to ensure that budgeting decisions are compatible with required rules and regulations."[30]

If the Agency had required stronger construction management practices and audit and compliance functions to be in place before agreeing to issue the bonds on behalf of Fletcher Allen, perhaps questionable spending and cost overruns could have been prevented.

Recommendation 1

The Agency should use its statutory authority to require that borrowers have in place sound budget controls, construction management practices, and audit and compliance functions before the Agency agrees to issue tax-exempt bonds.

To assure these controls are in place, the Agency could require that the borrower's governing board:

- ***Review and report on how an institution is spending tax-exempt bond funds;***
- ***Review annual independent financial and performance audits to assure that bond proceeds are spent according to the terms of the financing agreements;***
- ***Submit details of proposed changes in scope of a project;***
- ***Report on periodic on-site inspections; and,***
- ***Provide appropriate construction updates to the Agency, BISHCA and the public.***

The Agency should assume its responsibility to ensure that borrowers promptly file all certifications and annual notices as agreed to in the bond financing agreements.

[30] *Report to The Audit Committee of The Board of Trustees of Fletcher Allen Health Care, Inc. Regarding The Renaissance Project*, PricewaterhouseCoopers LLP, February 10, 2003, pgs 48-49.

Observation 2

FAHC did not properly file requisitions to the Agency, and the Bond Trustee, for reimbursements from the Construction Fund, as required by bond financing agreements. The Agency approved these requests without proper documentation and disbursed at least $50 million in bond proceeds, allowing improper spending of tax-exempt funds.

Discussion

FAHC agreed to comply with a number of provisions to ensure that the tax-exempt bond proceeds would be used according to state and federal laws.

In the Tax Certificate and Agreement signed by FAHC on March 29, 2000, the hospital agreed to the following:

> "The Borrower expects that all of the property financed with the proceeds of the Bonds will be owned by a State or local governmental unit or an organization described in Section 5109(c)(3) of the Code throughout the entire stated term of the Bonds. No portion of the Project is or will be owned by Fanny Allen Hospital, Hotel Dieu. The Borrower reasonably expects that at least ninety-five percent (95%) of the proceeds derived from the sale of the bonds, including investment earnings thereon, will be used for activities directly related to the exempt purposes of the Borrower and are not associated with any **'unrelated trade or business'** (Emphasis in original.) within the meaning of Section 513(a) of the Code and not in a Private Use …"[31]

As of December 2, 2002 FAHC had reimbursed the Construction Fund more than $1 million because it had used tax-exempt bond proceeds to fund the design and construction of a private $55 million parking garage. Invoices detailing these costs had not been provided to either the Bond Trustee or the Agency until the State Auditor raised questions about the veracity of the items listed on various requisition forms on file with the Agency.

[31] Tax Certificate and Agreement, Part D, Section 2, signed by FAHC, dated March 29, 2000.

As of August 14, 2002 when our Office met with the Agency's Executive Director, Malcolm S. Rode, there were 19 Requisition Forms on file detailing reimbursements made to FAHC with tax-exempt bond proceeds. Our Office's review of these 19 Requisition Forms found that nine were missing key required information, according to the Trust Agreement between the Agency and the Chittenden Bank. [32]

According to this agreement, each Requisition Form is required to contain at least the following information:

- The item number of each such payment;
- The name of the person, firm or corporation to whom each such payment is due;
- The respective amounts to be paid excluding any applicable sales tax;
- The purpose by general classification for which each obligation to be paid was incurred; and,
- The obligations in the stated amounts have been incurred by the Hospital and are presently due and payable and that each item thereof is a proper charge against the Construction Fund and has not been paid.[33]

Of the 19 forms, eight were missing "the purpose by general classification of the work completed" to support FAHC's request to be reimbursed for nearly $30 million in construction payments to various vendors, including Macomber/Barton Malow (MBM), who is the general contractor for both the privately-financed parking garage and the state-approved Renaissance Project. (*See page 30 for a complete list of requisition requests made by FAHC to the Agency*)

Requisition 15, dated March 25, 2002 and accounting for $3,314,392 in reimbursements, was missing all backup detail. Requisition 9, dated September 26, 2001 and accounting for $576,801.41 was missing the name of two companies who were paid $4,900 and $12,250 apiece.

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[32] Article IV Sec. 404, Trust Agreement between the Agency and the Chittenden Trust Company, March 29, 2000.

[33] Ibid.

As well, some of the forms reviewed by this Office explicitly included money paid to design and construct the private parking garage.

Our Office found that at least $694,341.70 of tax-exempt bond proceeds was used to pay for permits that included, or solely identified, the parking garage, as well as the construction of temporary buildings and related excavation. These items were listed as individual line items on the supporting documents that accompanied the requisitions. At the time the bond proceeds were used to pay for these permits – between August 2001 and April 2002 – the Agency's bond counsel had notified FAHC verbally that it could not spend bond proceeds on anything related to the garage.[34]

From August 2001 to April 2002, FAHC used at least $694,341.70 of tax-exempt bond proceeds to pay for permits that included, or solely identified, the private parking garage. FAHC was told in June 2000 by the Agency that it could not spend bond proceeds on this garage.

In discussions with our Office, the Agency's Executive Director notes that since its inception in 1966 the Agency has no knowledge of a borrower misusing tax-exempt bond funds. Good faith compliance is the general rule of thumb when it comes to tax-exempt bond financing. However, the U.S. Internal Revenue Service has attempted to address the issue of non-compliance with bond financing agreements.

A report issued June 21, 2002 by the Advisory Committee on Tax Exempt and Government Entities (ACT), which has spent nearly 10 years reviewing the rules associated with tax-exempt borrowing, recommended a carrot and stick approach to create a "voluntary corrections program (ACT report Section IV)" to detect and prevent non-compliance with federal tax rule that regulate tax-exempt borrowing activities.

[34] Letter from Malcolm Rode, the Agency's Executive Director, to State Auditor Elizabeth M. Ready, August 23, 2002, p. 4.

This approach is described as follows:

> "The Carrot - Customers should be encouraged to correct any problems they discover on their own by a regime of no or substantially reduced penalties provided that some sort of correction can be obtained … customers should be encouraged to establish programs involving good faith compliance efforts or reviews or similar non-Service related audits of their programs to make sure they are in compliance.
>
> The Stick - The need for an active audit enforcement program, separate from the voluntary corrections program, cannot be overemphasized. TE/GE should have an active enforcement program, focusing on material issues and reckless non-compliers. Reckless or intentional non-compliers should be made to pay the cost of their noncompliance, both to encourage voluntary compliance and corrections and so that voluntary compliers do not end up paying a higher cost than non-compliers."[35]

The report further adds that non-compliers should be separated into three categories:

> **Intentional Non-Compliers**: Persons who are purposefully misusing the system to accomplish goals that are not consistent with the reasons for the tax-exempt status;
> **Malfeasing Non-Compliers:** Persons who are not meeting the requirements because they simply don't make an effort to develop what needs to be done to comply; and,
> **Unintentional Non-Compliers**: Persons who act in good faith, but don't comply in full either because they do not understand the requirements or due to inadvertence.[36]

[35] Report of the Advisory Committee on Tax Exempt and Government Entities (ACT), Voluntary Corrections Project Group, Section IV, page 4, June 21, 2002.
[36] Ibid, page 5.

The report notes that one challenge for issuers to create a successful audit program is that "experts are only involved with the bonds at the time the bonds are issued and ongoing review of programs is rare. Bond programs rarely are established with any kind of ongoing compliance or overview, apart from calculation or rebate."

Some states have developed in-house procedures and policies to help borrowers ensure they are paying attention to invoices that comprise the requisitions they submit for repayment from tax-exempt bond funds.

For example, the Massachusetts Health and Educational Financing Agency (MassHEFA) requires that any requisition item valued at more than $25,000 must include a detailed invoice in order to be approved for reimbursement.[37]

Recommendation 2
The Agency should require borrowers to properly file requisitions according to bond financing agreements before disbursing any reimbursements.

The Agency should use its statutory authority to exercise due diligence and oversight over tax-exempt bond proceeds, especially in those cases where self-reporting by borrowers is inadequate.

The Agency should strengthen its system of internal controls by monitoring and reviewing disbursement requests to ensure compliance with all bond financing agreements. The Agency should:

- ***Ensure that it has access to adequate staff, consultants or other means to independently verify the assertions made by borrowers; and,***
- ***Require detailed invoices to accompany requisitions for expenditures above a certain threshold, such as $25,000.***

[37] Discussion with MassHEFA staff with SAO, October 2002.

Observation 3

FAHC admits it misused tax-exempt bond proceeds issued by the Agency to pay for:

- ***Costs of more than $1 million associated with a privately-financed parking garage; and,***
- ***Items that did not have a CON issued by BISHCA.***

This appears to violate the terms of FAHC's bond financing agreements.

The Agency, and Bond Trustee, released at least $50 million in tax-exempt bond proceeds to FAHC without proof required on its forms that a CON had been issued by BISHCA in compliance with state laws, and without documentation of how the bond proceeds were spent in compliance with bond financing agreements.

Discussion

FAHC used bond proceeds for items that lacked a CON

FAHC has admitted that some state and local permit fees, part of the project's so-called "soft costs," were not provided to State health care regulators and this was not part of the hospital's CON-related spending cap of $173 million.[38]

On August 19, 2002 this Office requested supporting documentation from the Agency to demonstrate how FAHC had used tax-exempt bond proceeds. FAHC provided this documentation on December 2, 2002. From our review of invoices and other documents, it appears that bond proceeds were used to pay for numerous items that lacked a required CON.

In a letter from FAHC to BISHCA Commissioner Elizabeth Costle,[39] FAHC noted that under its CON for the Renaissance Project and the parking garage it was "approved to spend a total of $228 million. However, there are additional planned, but unapproved, expenditures related to the Renaissance Project that require BISHCA's review. We estimate that these expenditures total approximately $81.3 million, but this figure is subject

[38] Letter from FAHC Interim CEO Edwin Colodny to BISHCA Commissioner Elizabeth Costle, November 8, 2002, p. 2.

[39] Ibid.

The Tale of the Construction Funds

Series 2000A ($100 million series)
Requisition 1, March 29, 2000 (Reimbursement): $2,500,000
Requisition 2, April 21, 2000 (Issuance Costs): $207,930
Requisition 3, April 21, 2000 (Issuance Costs): $29,822
Requisition 4, April 21, 2000 (Issuance Costs): $29,720
Requisition 5, April 21, 2000 (Issuance Costs): $20,475
Requisition 6, May 30, 2000 (Issuance Costs): $34,200
Requisition 7, May 31, 2000 (Issuance Costs): $157,569.67
Requisition 8, April 21, 2000 (Issuance Costs): $1,500
Requisition 9, April 21, 2000 (Issuance Costs): $13,240.78

Requisition 1, August 17, 2000 (Construction): $5,752,297.52
Requisition 2, August 23, 2000 (Construction): $1,873,063.11
Requisition 3, February 21, 2001 (Project costs): $4,669,528
Requisition 4, June 25, 2001 (Project costs): $1,286,046
Requisition 5, June 25, 2001 (Project costs): $2,007,936
Requisition 6, June 25, 2001 (Project costs): $1,147,558
Requisition 7, August 27, 2001 (Project costs): $1,029,405
Requisition 8, September 12, 2001 (Project costs): $1,037,455
Requisition 9, September 26, 2001 (Project costs): $576,801.41
Requisition 10, December 10, 2001 (Project costs): $1,496,297
Requisition 11, December 20, 2001 (Project costs): $1,840,417.96
Requisition 12, January 22, 2002 (Project costs): $3,478,391
Requisition 13, February 6, 2002 (Project costs): $2,224,251.84
Requisition 14, March 26, 2002 (Project costs): $2,398,957.51
Requisition 15, March 26, 2002 (Project costs): $3,148,564
Requisition 16, April 16, 2002 (Project costs): $4,601,157
Requisition 17, June 5, 2002 (Project costs): $3,707,321.65
Requisition 18, July 17, 2002 (Project costs): $3,314,392
Requisition 19, July 25, 2002 (Project costs): $2,977,771.46
Requisition 20, September 18, 2002 (Project costs): $5,342,499.67
Requisition 21, November 25, 2002 (Project costs): $467,771.96

Series 2000B ($50 million series)
Requisition 1, March 29, 2000 (Reimbursement): $27,500,000
Requisition 2, April 21, 2000 (Issuance costs): $111,961.43
Requisition 3, April 21, 2000 (Issuance costs): $26,112.49
Requisition 4, April 21, 2000 (Issuance costs): $15,845
Requisition 5, April 21, 2000 (Issuance costs): $16,002.70
Requisition 6, April 21, 2000 (Issuance costs): $11,025
Requisition 7, April 21, 2000 (Issuance costs): $30,800
Requisition 8, April 21, 2000 (Issuance costs): $18,500
Requisition 9, April 21, 2000 (Issuance costs): $84,845.20
Requisition 10, April 21, 2000 (Issuance costs): $6,521.58

to continuing evaluation by us and close scrutiny by your staff. The unapproved expenditures include:

- The cost of construction and renovations projects in our existing facilities that are being done concurrently with the Renaissance Project ($8.1 million).
- Additions to elements of the Project approved in the amended CON ($900,000).
- Owner's construction expenses not included in the amended CON ($2 million).
- Demolition, site work, landscaping costs and expenditures for utility and infrastructure upgrades associated with the Project ($8.4 million).
- The costs of temporary facilities that were built to facilitate Project construction ($3.7 million).
- Fit-up costs to accommodate programs that were displaced as a result of the demolition of our existing buildings ($4.3 million).
- Historic preservation costs for the Mary Fletcher building required by our local zoning permits ($1 million).
- Planning, permitting and design fees for the Project that were not included in the amended CON ($12.9 million).
- Capital expenditures and operating expenses that Fletcher Allen incurred in connection with the land swap with the University of Vermont ($12.9 million).
- The costs of equipment and furnishings that will be installed in the Ambulatory Care Center and represent "new" capital investments ($27.1 million), as opposed to the replacement of existing equipment and furnishings."

In this letter, FAHC said it would ask state regulators to approve an amended CON to include these additional costs. FAHC, in its November 8, 2002 letter, said it will also ask BISHCA to add $5.4 million to the amended CON of $173.4 million for the Renaissance Project due to "various scope and cost changes." It will also ask BISHCA to approve the deposit of $11.3 million in a contingency fund. On February 7, 2003 FAHC submitted an application to amend its CON in order to spend an additional $129.3 million, for a total of $356 million.

The misuse of tax-exempt bond proceeds falls into two categories: Money used to pay for the privately-financed garage, and money used to pay for construction items or changes to the project that had not been reviewed and approved by BISHCA.

Parking Garage

On May 17, 2000, Dave Demers, FAHC's Vice President of Planning and Business Development, informed BISCHA that a third party was going to construct, own and operate its proposed parking garage, and as a result the hospital was removing the parking garage from its Renaissance Project CON.

FAHC sent a copy of this letter to the Agency, which then forwarded the letter to its Bond Counsel on May 30, 2000.

According to an August 23, 2002 letter from the Agency's Executive Director to the State Auditor:

> "Bond Counsel advised the Agency and Fletcher Allen that removing the garage from the CON would mean that no moneys [sic] in the Construction Funds could be used for the garage."

In this same letter, the Agency said that its Bond Counsel also determined that the construction project was large enough to absorb the tax-exempt bond proceeds without the garage.

In a July 12, 2000[40] update to health care regulators, hospital officials said they were removing the garage from the CON because the garage was:

- An attractive investment for a third party;
- Eliminates the need for spending patient care dollars on a non-patient care item; and,
- Helps keep the overall CON within bounds of the original amount.

FAHC now admits that it spent more than $1 million in tax-exempt bond proceeds from May of 2000 through April of 2002 on aspects of the project it told regulators and financiers were being pulled out of the CON and paid for by a third party.[41]

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[40] *Report of the Ad Hoc Committee Concerning Governance and Compliance Issues Relating to the Renaissance Project*, Fletcher Allen Ad Hoc Committee, November 15, 2002, p. 23.

[41] Letter from Roderick Whitney, FAHC Treasury Director, to Malcolm Rode, the Agency's Executive Director, December 2, 2002.

FAHC had agreed to a synthetic lease approach to financing the parking garage by early 2001.[42] The Ad Hoc Committee report states that on January 15, 2001:

> "David Sylvester circulated to David Cox, Kim Reidinger and Allen Martin a proposed letter to David Cox, confirming the decision to pursue a synthetic lease. In the letter, Mr. Sylvester stated that on January 11, the working group had identified the synthetic lease form of ownership, and that the synthetic lease would be treated as an operating lease for accounting purposes … and a loan for tax purposes (with Fletcher Allen treated as the asset owner)." This letter further stated that on January 16, 2001, "Allen Martin e-mailed David Cox, Bill Boettcher, Thad Krupka and Kim Reidinger that the '[synthetic lease] does not require a CON because it will appear as an operating lease on [Fletcher Allen's] books.'"[43]

In July 2001, FAHC completed the documentation for financing the construction of the garage, which meant that CSL would nominally construct, own and operate the garage. The final go-ahead was given on July 16, 2001 when the Executive Committee of the FAHC's Board of Directors approved the financing.[44]

In August 2001 Fletcher Allen Health Care received a permit from the Burlington Planning & Zoning Department for Phase "O" of their project, which consisted of "site excavation and foundations for all proposed buildings, including the Central Plant, Ambulatory Care Center, Education Center and parking garage." The Development Review Fee for this phase of the project was $52,532.00, which Fletcher Allen paid on August 31, 2001. Fletcher Allen was reimbursed with tax-exempt bond proceeds from the Construction Fund established by the 2000A Series on September 26, 2001, according to Requisition 9 approved by the Agency.

42 *Report of the Ad Hoc Committee Concerning Governance and Compliance Issues Relating to the Renaissance Project*, Fletcher Allen Ad Hoc Committee, November 15, 2002, p. 34.

43 Ibid.

44 Ibid, page 41.

On April 10, 2002 FAHC paid the City of Burlington's nearly $470,000 for a permit issued by the Department of Public Works that reads under "Description of Work:"

> "HOSPITAL CONSTRUCTION: ACC, EDUCATIONAL CENTER, PARKING GARAGE, AND CENTRAL PLANT SUPER STRUCTURE STRUCTURE, SHELL AND CORE".

FAHC was reimbursed in full for this permit with tax-exempt bond proceeds on April 16, 2002, according to Requisition 16 approved by the Agency.

On August 19, 2002 our Office first requested the Agency to provide supporting documentation related to the 19 requisitions to ensure the tax-exempt proceeds were being used appropriately.

According to a letter from the Agency to our Office on September 6, 2002 an unnamed FAHC representative told the Agency that the hospital would fully document its repayment of garage-related funds by "netting them out of future invoices" submitted to the Agency. In conversations with our Office, Agency officials indicated that FAHC official was Roderick Whitney, FAHC's Treasury Director.

On December 2, 2002 – nearly four months after our initial request via the Agency – FAHC submitted 27 binders of supporting documents for the 21 requisitions that it had filed.

In Requisition 21, dated November 25, 2002, FAHC repaid $731,168.50 to the Construction Fund. This is in addition to $357,309.12 that was "credited back" in Requisition 20 dated September 2002, according to Roderick Whitney in a letter to the Agency on December 2, 2002.

To date, FAHC has repaid the Construction Fund $1,088,477.60. Most of these funds - $820,082.00 - were spent after May 17, 2000 when FAHC informed state regulators it was pulling the garage from its CON-approved project.

Upon review, however, it appears as if further problems exist with these supporting documents and not all garage-related costs may be properly identified. For example:

- There are no supporting invoices for any of the Series 2000B requisitions. As of August 19, 2002 there was one project-related requisition (Requisition 1, dated March 29, 2000) with a list of items totaling $27.5 million in capital costs FAHC paid to itself with bond proceeds;

- There is no supporting invoice for Requisition 1, dated March 29, 2000 for a $2.5 million request for "Network/PC Rollout (computers)" for project-related costs;

- Seven separate fees, totaling $440,527.79, paid to the City of Burlington appear to be related to the private parking garage, according to documents on file with the city's Burlington Planning & Zoning and Public Works departments. As of December 2, 2002 no money was re-allocated from these invoices to the Construction Fund;

- There are two Requisition 1s for the Series 2000A Bonds. The first is dated March 29, 2000 (noted above) and the second is dated August 17, 2000 for more than $5.7 million in project-related construction costs. The supporting documentation provided by FAHC does not rectify this duplication, nor explain it; and,

- In calculating garage-related spending from a number of early invoices, FAHC used a pro-rated percentage rather than exact, detailed invoices to determine the re-allocation amount. The formula used to determine these amounts should be verified and examined.

FAHC explained, in a February 14, 2003 letter to the Agency, the various formulas it used to reallocate, to date, more than $1 million that was originally paid in error from the Construction Fund. Of this amount, $357,309.12 was directly related to the parking garage and did not need an allocation formula. The remaining $674,793.61 reallocated to the Construction Fund paid for "soft costs." FAHC noted in its letter:

> "[M]any of the 'soft costs' for the Renaissance Project and the Parking Garage are billed to Fletcher Allen on a single, combined invoice that does not allocate the costs between the Renaissance Project and the Parking Garage. Fletcher Allen must then make an allocation between the projects for each combined invoice.
>
> Fletcher Allen developed allocation methodologies for these types of combined invoices in June 2001 when Fletcher Allen was preparing the budget for the Parking Garage in connection with the CSL transaction."[45]

FAHC also noted in this letter that some of its reallocations were made in error, and future adjustments would be made in a requisition presented to the Agency. FAHC also noted that it would review other state and local permits to re-assess the allocations it has made to date.[46]

The Agency's Bond Counsel believes these corrective procedures are "sufficient to remedy any issues that might have adversely affected the tax exemption of interest on the Bonds as a result of any garage-related requisitions. Federal tax regulations also permit reallocations of tax-exempt bond proceeds up to 18 months after a bond-finance project has been placed in service."[47]

Other Non-CON related spending

The use of tax-exempt bond funds to undertake construction activity that is not yet fully approved works against the purpose of CON regulations, which are in place to help keep the costs of health care in check.

Institutions can, and occasionally do, according to Agency officials, go out to bond for the future purchase of capital equipment. This allows the institution to put money aside for future anticipated debt, usually spent during a three-year period. Institutions may also pay off outstanding debt from certain past-approved projects as allowed by federal income tax laws.

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[45] Letter from Roderick Whitney, FAHC's Treasury Director, to the Agency, February 14, 2003, p. 2.

[46] Ibid, p. 4.

[47] Letter from Max Von Hollweg, Agency Bond Counsel, to Agency Executive Director Malcolm S. Rode, February 27, 2003, p. 1.

For example, FAHC was reimbursed $27.5 million for various capital expenditures, according to Requisition 1 of the Series 2000B bond proceeds dated March 29, 2000. According to this Requisition, the items under "Building and Leasehold Improvement" include:

- $1,816,650 – 35 Joy Drive (building);
- $180,000 – 35 Joy Drive (land);
- $2,074,057 - MRI Building expansion; and,
- $6,863,247 – Fanny Allen Hospital rehabilitation building project.

The items under "All Other Assets" include:

- $2,126,300 – Telecommunications System (paid to date);
- $1,826,900 – Horizon MRI system; and,
- $653,309 – Network/PC Rollout (computers). This item description also appears on the Series 2000A Requisition 1 as a $2.5 million reimbursement.

FAHC did not provide copies of the CONs to the Agency, and it is unclear whether a CON was needed, for any of the above projects. The Agency's Executive Director told our Office in an interview:

> "Often hospitals bond for equipment that is not yet purchased. But, they certify that they will get a CON if they need one in order to get money from the Construction Fund."

According to CON regulations[48] health care facilities are subject to CON review when they propose to offer a "new institutional health service." According to the Statute, such a service includes:

> "The construction, development, or other establishment of a new health care facility except for the purchase or lease of an existing health care facility other than the purchase of a hospital;

[48] 18 VSA § 9434.

Any expenditure by or on behalf of a hospital in excess of $1,500,000 or any expenditure by or on behalf of any other health care facility in excess of $750,000, which, under generally accepted accounting principles, consistently applied, is a capital expenditure;

Acquisition by purchase, or by lease or other comparable arrangement, by or on behalf of a health care provider of a single piece of diagnostic or therapeutic equipment for which the cost, or in the case of a donation the value, is in excess of $500,000. For purposes of this subdivision, the purchase or lease of one or more articles of diagnostic or therapeutic equipment which are necessarily interdependent in the performance of their ordinary functions or which would constitute any health care facility included under section 9432(10)(B) of this title, as determined by the commissioner, shall be considered together in calculating the amount of an expenditure. The commissioner's determination of functional interdependence of items of equipment under this subdivision shall have the effect of a final decision and is subject to appeal under this subchapter;

A change from one licensing period to the next in the number of licensed beds of a health care facility through the addition or conversion, or through the relocation from one physical facility or site to another;

The offering of health services in or through a health care facility which were not offered on a regular basis in or through such health care facility within the twelve-month period prior to the time such services would be offered if such services have an annual operating expense in excess of $300,000 or the offering of any home health services;

The purchase of an existing hospital;

The offering of any cardiac catheterization laboratory service."

Aside from the items listed above in Requisition 1 of the Series 2000B totaling $27.5 million, this Office reviewed additional supporting documents FAHC submitted to the Agency.

Our review found that FAHC used tax-exempt bond proceeds to pay for items that it has revealed it hid from regulators.[49] In addition, FAHC knowingly spent above its amended CON-approved cap of $173.4 million. In his November 8, 2002 letter to Commissioner Costle, FAHC's Interim CEO Edwin I. Colodny disclosed that FAHC intended to ask regulators to approve $8.4 million for "Demolition, site work, landscaping costs and expenditures for utility and infrastructure upgrades associated with the Project."[50] Of the $88.3 million that FAHC has now identified as being related to the Renaissance Project, and not previously disclosed to State regulators, the hospital has already spent $34.6 million.[51]

Supporting documents provided by FAHC and reviewed by this Office reveal that the hospital has already paid for much, if not all, of this work out of tax-exempt bond proceeds. Specifically:

- In Requisition #15 (Exhibit 21, Invoice 72401 dated February 25, 2002), Macomber/Barton Malow billed $799,333.60 to FAHC, which then paid these costs with tax-exempt bond proceeds, to pay fees associated with site excavation, backfill, metal structures and foundation work in the "Construction Phase of C.O.N." It is not clear if the work being done by these firms is related to the parking garage, the Renaissance Project or both. The firms identified with assisting with the mass excavation, backfill and foundation work include: J.A. McDonald ($58,691.61); PGI (Pizzagalli, Griswold, Ireland), A Joint Venture ($559,698.20); Schnabel Foundation Co. ($38,262.60); Supermetal Superstructures ($120,418.92).

- In Requisition #15 (Exhibit 22, Invoice 72400 dated February 26, 2002), Macomber/Barton Malow billed $1,214,665.40 to FAHC, which then paid the costs with tax-exempt bond proceeds, to pay fees associated with site excavation, backfill, metal structures and foundation work in the "Construction Phase of R.A.P." It is not clear if the work being done by these firms is related to the parking garage, the Renaissance Project or both.

49 Letter from FAHC Interim CEO Edwin Colodny to BISHCA Commissioner Elizabeth Costle, November 8, 2002, pgs 1-2.

50 Ibid, p. 3.

51 Application for an Amended Certificate of Need for the Renaissance Project, FAHC submission to BISHCA on February 7, 2003, p. 39.

• In Requisition #16 (Exhibit 5, Invoice 72797 dated March 28, 2002) Macomber/Batton Malow billed $3,489,154.43 to FAHC, which then paid the costs with tax-exempt bond proceeds, to pay for site excavation, backfill, metal structures and foundation work in the “Construction Phase of C.O.N.” It is not clear if the work being done by these firms is related to the parking garage, the Renaissance Project or both. The firms identified with assisting with the mass excavation, backfill and foundation work include: J.A. McDonald ($57,960.00); PGI (Pizzagalli, Griswold, Ireland), A Joint Venture ($2,152,173.80); S.D. Ireland ($78,790.68); Schnabel Foundation Co. ($54,000.00); Supermetal Superstructures ($487,271.18).

• In Requisition #16 (Exhibit 6, Invoice 72795 dated March 28, 2002) Macomber/Batton Malow billed $595,433.46 to FAHC, which then paid the costs with tax-exempt bond proceeds, to pay for “Construction Phase of R.A.P.” It is not clear if the work being done by these firms is related to the parking garage, the Renaissance Project or both.

The amounts of these four invoices total $6,098,586.89.

Our Office’s review of supporting documents for Requisitions 17, 18, 19, and 20 found similar lack of detailed information for invoices related to “Construction Phase of C.O.N.” and “Construction Phase of R.A.P.”

The Contractor’s Application for Payment that accompanies all bills for the “Construction Phase of C.O.N.” invoices includes a line item “Original Contract Value.” This value is stated as $142,166,599.00 for this batch of invoices.

The Contractor’s Application for Payment that accompanies all bills for the “Construction Phase of R.A.P.” invoices also includes a line item “Original Contract Value.” This value is stated as $26,185,856.00 for this batch of invoices.

Recommendation 3

Before disbursing any payments the Agency should require borrowers to provide proof that a CON has been issued by BISHCA (when necessary), and documentation that bond proceeds are properly spent in compliance with all financing agreements.

The Agency should hire an independent audit firm to conduct a forensic audit of the requisitions and invoices submitted by FAHC in order to independently verify compliance with applicable State and Federal laws, and the bond financing agreements.

A forensic audit could reveal any further questionable costs paid with tax-exempt bond proceeds. The cost of this audit would be paid for with bond proceeds, which is an allowable use of tax-exempt bond proceeds.[52]

[52] Article III, Section 3.04(b)(iv) of the Loan Agreement between FAHC and the Agency, February 1, 2000.

Observation 4

There is no communication between the Agency and BISHCA.

If BISHCA had received copies of construction requisitions and invoices produced by the hospital, spending irregularities could have been caught earlier, potentially saving millions of dollars.

Discussion

The use of tax-exempt bond funds for construction activity that is not yet fully approved by health care regulators works against the goal of reining in the costs of construction projects and the impact they have upon health care costs.

If BISHCA had received copies of construction requisitions and invoices produced by the hospital, spending irregularities could have been caught at an earlier date – as early as July of 2000 - potentially saving millions of dollars.

These costs included excavation, permit fees to demolish buildings and construct temporary buildings that were not included in the original CON or project description. These costs also include items (*listed in Observation 1*) that are not related to the construction of the Renaissance Project or the parking garage.

A potentially overarching issue is that the Agency approves bond issuances that include spending for “routine capital improvements and equipment for various health care facilities operated by the Borrower,” according to various bond financing documents on file with the Agency.

These improvements, which typically are not related directly to the construction project, may or may not need a CON depends on whether or not they meet the various standards in the State’s CON regulations. And, the Agency operates under the principle that if the hospital is required to get a CON for any project they either have one or will get one. (*See Observation 3, pages 36-40*). However, as FAHC’s Ad Hoc Committee report noted, the hospital has been operating under a self-described “culture of withholding information.”

On each Requisition form submitted by FAHC for reimbursement from the Construction Fund is the following statement:

> "If such obligation payable has received a certificate of need, a copy of such certificate of need is attached, or if such obligation payable has not received a certificate of need, attached is an Opinion of Counsel, in form and substance satisfactory to the Bond Trustee and the Agency, that no certificate of need is required with respect to such obligation payable."

State regulators at BISHCA told FAHC on December 14, 2001 and again on January 29, 2002 that moving ahead with the construction of the Birthing Center on the seventh floor of the McClure wing was done so "at their own risk." And, these changes needed to be reviewed by BISHCA before Fletcher Allen would receive official state approval.

In her December 14, 2001 letter, BISHCA Commissioner Betsy Costle said:

> " … please note that the outcome of such a review may be approval, approval in part or denial. While this review is pending, therefore, Fletcher Allen Health Care proceeds with the changes outlined in its implementation report and addenda at its own risk."[53]

This letter was not shared with the Agency, and on July 25, 2002 the Agency approved a Requisition that included a $9,600 permit payment to Burlington's Department of Public Works that allowed Fletcher Allen to:

> "ENLARGE SWVENTH (sic) FLOOR ON MCCLURE BUILDING FOR A NEW BIRTHING CENTER."(capitalization from original permit document)

During its review of FAHC's construction project BISHCA – on several occasions – said it would not use it statutory authority to slow down, or halt, certain aspects of the project that were being built without a proper CON because it could cause FAHC to default on it bonds.

[53] Letter from Elizabeth Costle, BISHCA Commissioner, to David M. Demers, Senior Vice President, Planning and Business Development, December 14, 2001.

As early as July 7, 2000, FAHC representatives informed BISHCA that Hedge Bond Rules, if strictly applied, meant that there was little room to spare in terms of allowing for additional review of the project. In its letter, FAHC said:

> "In particular, there are only three months of cushion before the date on which the 30% test must be met at the end of year two. If our construction schedule is delayed, these three months of cushion can evaporate very quickly. Although the Hedge Bond Rules are applied at the time that a particular financing closes rather than retrospectively, with 20/20 hindsight, it is still critically important to keep the Project on schedule."[54]

BISCHA appeared to adopt FAHC's conservative view of the rules governing the time-frame during which bonds must be expended. The Agency's Bond Counsel is now also stating it shares this conservative view.[55]

The Hedge Bond Rules outlined in the Tax Certificate and Agreement signed on March 29, 2000 by FAHC, as part of its financing agreement with the Agency, includes the following language governing the timeframe by which tax-exempt bonds funds need to be expended:

> "The Borrower expects that at least eighty-five percent (85%) of the net sale proceeds (as such term is defined in Treasury Regulation Section 1.148-1(b)) of the Bonds will be allocated to expenditures for the Project, including Capitalized Interest, within five (5) years from the date hereof."[56]

It is important to note that FAHC's original CON for the construction project was $118 million. That was increased to $173 million (without the $55 million private parking garage) in an amended CON issued in 2000. Now, FAHC has submitted a total project cost of $326 million.

---

[54] Letter Priscilla Reidinger, FAHC General Counsel, to Stan Lane, BISHCA Health Policy Analyst, July 7, 2000.

[55] Letter from Agency Executive Director Malcolm S. Rode to State Auditor Elizabeth M. Ready, February 27, 2003, p. 3.

[56] Tax Certificate and Agreement, Part B, Section 2, signed by FAHC on March 29, 2000.

Despite the increasing costs associated with the project, this conservative view of the Hedge Bond Rules affected a number of BISCHA policy decisions.

On December 12, 2000 BISHCA denied party status to Business Review Services. This denial came prior to the review of FAHC's application to amend its CON to increase the overall cost of the Renaissance Project to $173 million and remove the parking garage. Business Review Services, which negotiates insurance plans on behalf of groups of small employers, was concerned about the project's rising cost and its impact on insurance rates.

In her denial letter, BISHCA Commissioner Elizabeth Costle said:

> " … allowing BRS party status at this late date would substantially and irreparably harm Fletcher Allen's interests in the unappealed CON that I issued eighteen months ago. The bonds that were issued to Fletcher Allen to finance the approved project have requirements surrounding construction spending that, if delayed, would harm FAHC's ability to finance the project under the approved terms of the original CON."

In a July 15, 2002 press release issued by BISHCA announcing that it had issued a CON for the parking garage, BISHCA Commissioner Elizabeth Costle said:

> "After careful review of all of the facts, I concluded that the hospital's application for the parking garage should be approved because stopping the project could have had very serious consequences for Vermont."

In this press release, BISCHA also stated:

> "Not issuing the CON could have resulted in default on $55 million of construction financing, default on $150 million of Fletcher Allen's tax-exempt bonds, and the shutdown of the entire Renaissance Project."

The Agency's Executive Director, Malcolm Rode, said it was his opinion that the spending targets included in the bond agreement are flexible, and the failure to adhere to the exact dollar and date would not cause a default of the bonds. However, "BISCHA never called this Office to ask for our opinion, they just said what the hospital told them."[57]

Rode further added: "I don't hear from them and they (BISCHA) don't seem to be interested in us. In the past, I have invited BISCHA to [the Agency's] board meetings, and their attendance was irregular. After a while, I guess I just stopped making invitations to them. So, I guess I'm as much at fault as they are."[58]

Recommendation 4

The Agency should require borrowers to supply BISHCA with copies of all requisitions and supporting documents related to requests for reimbursements with tax-exempt bond proceeds.

The Agency should also notify BISHCA of public hearings when a bond issuance is approved and provide copies of all relevant information pertaining to the project's description and financing arrangement(s).

57 Telephone interview with SAO staff on August 21, 2002.

58 Interviews with SAO staff on August 8, 2002 and February 18, 2003.

Appendix A

Vermont Educational & Health Buildings Financing Agency's
Response to Draft Assessment

Vermont Educational and Health Buildings Financing Agency

Malcolm S. Rode
Executive Director

FEB 28 2003

MEMO

TO: Elizabeth Ready
State Auditor

FROM: Malcolm S. Rode, Executive Director MSR

DATE: February 27, 2003

SUBJECT: **Comments on Draft Report**

The following are technical comments and suggested changes received from bond and tax counsel.

Page 2. Second paragraph, second sentence should read: Since its inception in 1966 it has served as a successful vehicle for the state's non-profit hospitals and colleges to secure access to low-interest, tax-exempt financing for their construction projects.

Third paragraph should be changed to: In addition to offering market access [and] to low interest rates…

Page 4. Paragraph one, second sentence should be changed to: This provides these institutions with access to the tax-exempt capital markets, [keeps] with its lower interest rates [low] and provides…

Page 5. Second paragraph, first sentence should be changed to: Current federal tax laws allow the Agency, on behalf of any eligible institution, to issue bonds or notes for eligible projects on a tax-exempt basis. An additional sentence should be added: The Agency has no taxing power.

Third paragraph should be changed to: By [federal] state law, the Agency is only allowed to finance the construction of buildings and related equipment needs specific to the project described to financiers and potential bondholders. The Agency cannot fund what is known as "working capital". [or routine capital expenses that an institution must replace or upgrade on a periodic basis as part of doing business.]

133 State Street, 2nd Floor, P.O. Box 564, Montpelier, Vermont 05601-0564
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Federal income tax law allows the financing of working capital under certain circumstances and does not distinguish between routine capital expenditures and expenditures for specified projects.
Paragraph four, last sentence should be changed to: And, certain health care facilities must also, if required, have a Certificate of Need (CON) issued by BISCHA to be eligible.

Page 6. Paragraph two, fourth sentence should be changed to: The working group consisted of members of FAHC, VEHBFA, their lawyers, bond analysts, underwriters, financial advisors and others.

Paragraph three should have the following added: This included $100 million of refunding authority that was never used.

Paragraph five, seconded sentence should be changed to: The bonds were used to fund the construction of the Renaissance Project [, refinance some old debt,] and pay [off] certain other capital costs.

Page 9. Last paragraph in observation 1 should be changed to: The [Agency] Trustee released at least $50 million in tax-exempt bond proceeds to FAHC without proof required on its forms that a CON had been issued by BISHCA in compliance with state [and federal] laws…

At closing the bond trustee assumes all enforcement powers and has final control of the construction fund.

As far as CON is concerned the Agency had copies of the 1999 CON and relied on the certificates from Fletcher Allen, as permitted in the Loan Agreement, Section 4.03, that they had CON, if required, for all other requisitions of bond proceeds.

Page 15. Paragraph four. Supporting documentation for the 2000 B reimbursement for prior capital equipment is contained in the Series B Tax Certificate.

Page 16. Second paragraph under ***other Non-CON spending*** is technically incorrect. Bond issues are sized so that the Agency and the Borrower reasonably expect to spend all of the proceeds on qualifying projects. Bonds cannot be issued in a greater amount that is needed for a particular project, and certainly not to allow institutions to put money aside for future anticipated debt. Of course bonds can be issued to refinance qualified existing debt that is contemplated at the time of sizing.

Page 23. Last paragraph. They are concerned that the use of bond proceeds to pay costs of a forensic audit could be treated as a working capital expense for tax purposes.

Page 24. First paragraph, First sentence should be changed to FAHC did not properly file requisitions to the Agency <u>and the Bond Trustee</u> for reimbursements.... The second sentence should be changed to: The Agency <u>and the Bond Trustee</u> approved...

Page 25. Quotes from the tax certificate are taken out of context. Leases to third parties engaged in a trade or business will not be eligible for the public use exception to the definition of "private use" which is quoted at the top of page 25.

Page 42. Second paragraph. The statement that BISCHA appeared to adopt FAHC's conservative view of the rules governing the timeframe during which bonds must be expended is also Bond Counsel's view. They suggest you see the Tax Certificate Part E Section 1(a) Hedge Bond Rules.

Page 43. The Agency used to invite BISCHA to board meetings and occasionally they would attend. After a time of not having anyone attend the Agency stopping sending invitations.

The memorandum fails to take into account federal income tax regulations that permit reallocations of bond proceeds within 18 months after a project is placed in service so long as such allocation is made within five years after the issue date. Assuming that the project has not been placed in service for 18 months, it should be noted the Agency could still make timely allocations of proceeds away from the garage for federal tax purposes, if necessary.

This letter should not be construed as any agreement by the Agency with the observations and conclusions in your report.

cc: Max Von Hollweg, Sidley Austin Brown & Wood
James Foley, Jr., Deppman & Foley
Ethan Allen, Jr., VEHBFA Chair

Appendix B

Bond Counsel's Review of Covenant Violations
(& Fletcher Allen Health Care's Response)

SIDLEY AUSTIN BROWN & WOOD LLP

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WRITER'S DIRECT NUMBER
(212) 839-5517

February 27, 2003

Malcolm S. Rode
Executive Director
Vermont Educational and Health Buildings
Financing Agency
133 State Street
Montpelier, VT 05633-6200

Re: Vermont Educational and Health Buildings Financing Agency
Hospital Revenue Bonds (Fletcher Allen Health Care Project)
Series 2000A and Series 2000B (the "Bonds")

Dear Kim:

As you know, we acted as bond counsel in connection with the issuance of the above-referenced Bonds. We have also reviewed and discussed with you the August 14, 2002 e-mail and August 19, 2002 letter you received from the State Auditor's office and your August 23, 2002 letter in response thereto, the August 29, 2002 letter you received from the State Auditor and your September 4, 2002 response thereto, the December 2, 2002 and February 14, 2003 letters you received from Fletcher Allen Health Care ("Fletcher Allen"), and the December 5, 2002 and December 13, 2002 letters you received from the State Auditor.

We have reviewed the corrective procedures and allocation methodology by which certain bond proceeds which had been requisitioned from the Construction Fund for the Series 2000A Bonds for expenditures related to Fletcher Allen's underground parking garage have been subsequently reimbursed to that Construction Fund. We note, as did you in your August 23rd letter to the State Auditor, that we had advised Fletcher Allen in June of 2000 that bond proceeds could not be requisitioned to pay garage-related expenditures if the garage was to be removed from the then-applicable CON. We also note, as Fletcher Allen stated in its December 2nd letter to you, that Fletcher Allen believes any garage-related requisitions had been inadvertently submitted. Please be advised that we believe that the corrective procedures referred to above were sufficient to remedy any issues that might have adversely affected the tax exemption of interest on the Bonds as a result of any garage-related requisitions. Federal tax regulations also permit reallocations of tax-exempt bond proceeds up to 18 months after a bond-financed project has been placed in service. In addition, we note that a CON has since been issued in 2002 specifically for the parking garage, thus making garage-related expenditures once again reimbursable under the bond documents.

The State Auditor, in its December 13th letter to you, discusses Sections 6.06 of the Loan Agreements related to the Bonds and Section 801(c) of the Trust Agreements related to the Bonds. Those sections concern Events of Default. Failure by Fletcher Allen to comply with a covenant under the Loan Agreements does not ripen into an Event of Default thereunder until Fletcher Allen has been notified in writing of such failure by the Bond Trustee or by Ambac Assurance (the insurer of the Bonds), acting in lieu of the Bondholders, and given a 30-day opportunity to cure. See Section 6.01(b) of the Loan Agreements. Fletcher Allen has informed us that no such written notice has been given to Fletcher Allen. Therefore, to our knowledge, no Event of Default under those sections has occurred.

Had there been an Event of Default under the Loan Agreements, it would also have constituted an Event of Default under the Trust Agreements pursuant to Section 801(d) thereof. As the State Auditor noted, Section 801(c) of the Trust Agreements also provides that covenant defaults of the Agency under the Trust Agreements can also ripen into Events of Default thereunder, but, as in the case of Events of Default under the Loan Agreements, again only after the Agency has received written notice from the Bond Trustee and been given an opportunity to cure. You have informed us that no such written notice has been given to the Agency. Therefore, to our knowledge, no Event of Default under those sections has occurred.

Finally, the State Auditor's December 13th letter also discusses Section 3.10(b) of the Master Trust Indenture which requires the filing with the Master Trustee of Fletcher Allen officer's certificates as to the absence of covenant defaults on an annual basis. We note, as have you in your August 23rd letter, that enforcement of the bond documents is the primary responsibility of the Master Trustee and the Bond Trustee. As for our role, unless asked for our advice on specific matters, we are not involved in the administration or enforcement of the bond documents after a transaction has closed. We have, at your request, discussed Section 3.10(b) with Fletcher Allen and its counsel and have been informed that the annual officer's certificates required to be filed have not in fact been filed, either with the Master Trustee or, pursuant to Sections 5.04 of each of the Loan Agreements related to the Bonds, with the Agency, Ambac Assurance or the Bond Trustee (which is the same entity as the Master Trustee). We advised Fletcher Allen (1) to, of course, comply with those provisions going forward and (2) to notify the relevant parties of any prior non-compliance and to request waivers of the effect of such non-compliance. Fletcher Allen has informed us that none of the parties entitled to receive the annual no-default certificates has ever notified Fletcher Allen of its failure to deliver the required certifications. In addition, Fletcher Allen has informed us that it has received waiver letters or assurances of no default from all relevant parties to the bond documents with respect to the failure to file the annual officer's certificates.

Failure to file the required certifications raises two issues – the first procedural and the second substantive. The procedural issue relates to the failure to file the certificate itself which, once such failure occurs, constitutes a covenant default. The substantive issue relates to what the certification would have said about covenant defaults had it been timely filed. We have reviewed the officer's certificate dated February 24, 2003, filed by Fletcher Allen pursuant to Section 3.10(b) of the Master Indenture and Section 5.04 of the Loan Agreements for Fiscal Year 2002 and believe it to be responsive to the formal requirements of the Master Indenture, noting only that it was filed later than the required January 31. We have also been advised that Fletcher Allen has filed an additional certification to the effect that, among other things, Fletcher Allen was not in default in the performance of any covenant contained in the Master Trust Indenture as of the close of Fiscal Year 2001.

Very truly yours,

Max Von Hollweg

Max Von Hollweg

MV:maj

Fletcher Allen HEALTH CARE

In alliance with The University of Vermont

February 27, 2003

VIA HAND DELIVERY

Malcolm S. Rode, Executive Director
Vermont Educational and Health Buildings Financing Agency
133 State Street, 2nd Floor
P.O. Box 564
Montpelier, Vermont 05601-0564

Re: Fletcher Allen Health Care, Inc.

Dear Mr. Rode:

You have previously provided us with a copy of the letter to you from the State Auditor dated December 13, 2002 (the "Auditor's Letter"). The Auditor's Letter sought clarification of the following three (3) issues:

- What is the basis of the methodology that was used to reallocate garage related expenditures to the Construction Fund?

- In the opinion of Bond Counsel to the Agency, has Fletcher Allen appropriately filed certificates of no default in accordance with Section 3.10(b) of the Master Trust Indenture ("MTI") between Medical Center Hospital of Vermont, Inc., predecessor of Fletcher Allen, and Chittenden Trust Company dated as of January 1, 1993?

- In the opinion of Bond Counsel, did the reallocation of garage related expenditures to the Construction Fund constitute an "Event of Default" under Section 6.06 of the Loan Agreement between Fletcher Allen and the Agency dated February 1, 2000 (the "Loan Agreement") and/or Section 801(c) of the Trust Agreement between the Agency and Chittenden Trust Company dated February 1, 2000 (the "Trust Agreement")?

The first issue, concerning Fletcher Allen's reallocation of garage related expenditures, was addressed in detail in our letter to you dated February 14, 2003. A copy of that letter is attached hereto as Exhibit A for your ease of reference.

We note that Bond Counsel, by letter to you dated February 27, 2003 ("Bond Counsel's Letter"), has confirmed that Fletcher Allen's corrective procedures concerning the reallocation were sufficient, and, therefore, the tax-exemption of interest on the Series 2000 Bonds has not been adversely affected.

The second and third issues raised in the Auditor's Letter are addressed in Bond Counsel's Letter. We would like to briefly comment on the issues analyzed by Bond Counsel:

With respect to the second issue, Bond Counsel accurately states that Fletcher Allen has not filed annual certificates of no default in accordance with Section 3.10(b) of the MTI. This was because Fletcher Allen believed that the annual letters from its auditors under Section 3.10 satisfied this requirement. In any event, at the suggestion of Bond Counsel, Fletcher Allen has obtained either waiver letters or assurances of no default from all relevant parties to the Series 2000 Bonds in connection with Fletcher Allen's failure to file the required certificates. As noted in Bond Counsel's Letter, none of the parties entitled to receive the annual certificates under Section 3.10(b) of the MTI have ever notified Fletcher Allen of its failure to file the certificates. Further, none of the parties have declared such failure to be a default under the MTI.

We are enclosing for your records, as Exhibit B to this letter, an officer's certificate, dated February 24, 2003, under Section 3.10(b) of the MTI, and a supplemental officer's certificate, dated February 27, 2003, with regard to Fiscal Year 2001. These certificates certify, as required, that Fletcher Allen is not in default in the performance of its covenants under the bond documents and that there are no defaults from earlier years that remain uncured, with the exception of the timely filing of the officer's certificates, which of course cannot be corrected.

Going forward, Fletcher Allen is committed to the timely and accurate filing of the annual certificates required by Section 3.10(b). The certificate for Fiscal Year 2002 was due by January 31, 2003. Fletcher Allen submitted the certificate of no default to you, along with the audited financial statements under Section 3.10(a), on February 26, 2003. We apologize for the lateness of the filing; however, Ernst & Young LLP could not opine upon the FY 2002 financial statements until it had the opportunity to review and account for the findings of the forensic accounting work recently concluded by PricewaterhouseCoopers LLP.

With respect to the third issue, Fletcher Allen has not received any written notice of default under Section 6.06 of the Loan Agreement. To our knowledge, the Agency has not received any written notice of default under Section 8.01(c) of the Trust Agreement.

Therefore, we concur with Bond Counsel that the reallocation of garage related expenditures to the Construction Fund did not constitute an "Event of Default."

* * * * * * * * *

With this letter, and its attachments, we believe that the issues raised in the Auditor's Letter, and all prior correspondence, have been adequately addressed. Please let us know if that is not the case.

Lastly, the State Auditor has not provided Fletcher Allen with a copy of her report. We understand that the report is still in draft form. Until such time as the report is made available to Fletcher Allen, we are not able to comment on its contents and conclusions. We welcome the opportunity to do so once the State Auditor provides us with a copy of the report.

Thank you.

Very truly yours,

FLETCHER ALLEN HEALTH CARE, INC.

By: ______________________
Spencer R. Knapp, Esq.
Acting General Counsel

cc: Elizabeth M. Ready, State Auditor

Fletcher Allen HEALTH CARE

In alliance with
The University of Vermont

February 14, 2003

VIA FACSIMILE AND FIRST CLASS MAIL

Malcolm S. Rode, Executive Director
Vermont Educational and Health Buildings Financing Agency
133 State Street, 2nd Floor
P.O. Box 564
Montpelier, Vermont 05601-0564

Re: Fletcher Allen Health Care, Inc.: Allocation Methodologies

Dear Mr. Rode:

You have previously provided us with a copy of the letter to you from the State Auditor dated December 13, 2002 (the "Auditor's Letter"). The Auditor's Letter seeks clarification of three (3) issues. We understand that Bond Counsel for the Agency will be addressing the second and third issues enumerated in the Auditor's Letter. The first issue, concerning Fletcher Allen's allocation methodologies, is addressed below.

In relevant part, the Auditor's Letter reads as follows:

> "1. A number of the early requisitions included garage-related spending paid for with tax-exempt bond proceeds, and FAHC notes it is re-allocating $1,032,102.73 to the Construction Fund. The funds appear to be re-allocated on a flat-percentage rather than based on exact, detailed expenses related to the parking garage. You acknowledged in our conversation that garage related expenditures were in fact allocated to the Construction Fund on a prorated basis.
>
> What is the basis of the methodology that was used to reallocate garage related expenditures to the Construction Fund?"

To be clear, we must first note that $357,309.12 of the $1,032,102.73 (35%), represented by ten (10) invoices for architectural and design fees, was directly and entirely related to the underground parking garage (the "Parking Garage") being developed by CSL Leasing, Inc. ("CSL"). Therefore, Fletcher Allen did not use any allocation methodology to determine what portion of these invoices to credit back to the Construction Fund. Fletcher Allen simply credited the entire amount ($357,309.12) to the Construction Fund (twice, in fact). Our December 2, 2002 letter to you correctly points out that, since February 2001, none of Fletcher Allen's requisitions to the Agency have included invoices directly related to the Parking Garage.

The remaining $674,793.61, representing a portion of eighty-two (82) invoices submitted in Fletcher Allen's earliest requisitions, was originally paid, in error, from the Construction Fund. Fletcher Allen should have charged this amount to the Parking Garage, based upon the allocation methodologies described below. The $674,793.61 was credited back to the Construction Fund in Requisition # 21 dated December 2002.

As we explained in our December 2nd letter, many of the "soft costs" for the Renaissance Project and the Parking Garage are billed to Fletcher Allen on a single, combined invoice that does not allocate the costs between the Renaissance Project and the Parking Garage. Fletcher Allen must then make an allocation between the projects for each combined invoice.

Fletcher Allen developed allocation methodologies for these types of combined invoices in June 2001 when Fletcher Allen was preparing the budget for the Parking Garage in connection with the CSL transaction.

The eighty-two (82) invoices, totaling $5,785,027.14, represent combined invoices for "soft" costs that Fletcher Allen ultimately allocated between the Renaissance Project ($5,110,233.53) and the Parking Garage ($674,793.61) in May 2002 and credited back to the Construction Fund in December 2002.

The allocation methodologies, with respect to the eighty-two (82) invoices, are described as follows:

- Fletcher Allen allocated 16.8 % of thirty-five (35) invoices to the Parking Garage, for a total of roughly $275,000. All of the thirty-five (35) invoices relate to third party planning and design fees for both the Renaissance Project and the Parking Garage (i.e., surveying, estimating services, travel and reimbursables for the architect and the construction manager). The 16.8% is based upon the budgeted percentage of hard construction, i.e., the Parking Garage accounts for 16.8% of all hard construction dollars budgeted for the Renaissance Project and the Parking Garage. Fletcher Allen considered the percentage of hard construction cost as a more reliable allocation methodology than the competing alternative, percentage of square footage, due to the significantly higher cost per square foot of the Renaissance Project.

- Fletcher Allen allocated 6.2% of seventeen (17) invoices to the Parking Garage, for a total of roughly \$92,000. All of these invoices relate to insurance costs for the Renaissance Project and the Parking Garage. The 6.2% represents the Parking Garage's budgeted share of the overall insurance budget. Fletcher Allen will re-assess the allocation of the overall insurance budget as future invoices are received and the projects progress.

- Fletcher Allen allocated 10% of sixteen (16) invoices to the Parking Garage, for a total of roughly \$34,000. All of these invoices relate to permit consulting by Tsio/Kobus Associates ("TKA"), the architect of record. The 10% is based upon discussions with TKA in 2001. The Parking Garage was considered to require relatively modest consulting efforts by TKA because the Parking Garage does not implicate permit requirements concerning height, green space or lot coverage.

- Fletcher Allen allocated 5% of six (6) invoices to the Parking Garage, for a total of roughly \$56,000. All of these invoices relate to early master planning performed by TKA in 1999 for all Fletcher Allen sites, including the MCHV Campus. The 5% is based upon discussions with TKA in 2001. The master planning involved assessing the overall business and patient activities across all of Fletcher Allen's sites and facilities. The Parking Garage was not a major component of this work, hence the 5% allocation.

- Fletcher Allen allocated 8% of five (5) invoices to the Parking Garage, for a total of roughly \$57,000. Fletcher Allen has now determined that: (i) four (4) invoices related to additional master planning performed by TKA in 2000, and, therefore, should have been allocated at 5% (not 8%), consistent with the treatment of master planning in the preceding bullet, and (ii) the fifth invoice should have been allocated at 16.8%, consistent with the reasoning set forth in the first bullet. Fletcher Allen will reflect these adjustments in a future requisition.

- Fletcher Allen allocated 100% of two (2) invoices to the Parking Garage, for a total of roughly \$66,000. Similar to the ten (10) invoices constituting the \$357,309.12 noted above, these two (2) invoices related directly to TKA's architectural and design fees attributable to the Parking Garage.

- Fletcher Allen allocated 20.7% of one (1) invoice to the Parking Garage, for a total of roughly \$97,000. This invoice related to the building permit for the core and shell for both the Parking Garage and the Renaissance Project. The 20.7% represents the square footage of the Parking Garage in relation to the overall square footage of the Renaissance Project. Fletcher Allen will pull additional building permits for the projects in the future and will re-assess the allocations as the permits are pulled.

Fletcher Allen currently processes all combined invoices that it receives based upon these allocation methodologies.

Please let me know if you have any questions concerning this letter. Thank you.

Very truly yours,

Roderick Whitney

Roderick Whitney
Treasury Director

BTV/235839.1

Fletcher Allen Health Care, Inc.

Officer's Certificate pursuant to Section 3.10

of the Master Trust Indenture dated as of January 1, 1993

Fiscal Year 2002

I, Kenneth L. Fisher, DO HEREBY CERTIFY that:

1. I am the Interim Chief Financial Officer of Fletcher Allen Health Care, Inc. ("FAHC"), the Obligor under the Master Trust Indenture dated as of January 1, 1993 (the "MTI"), by and between FAHC and Chittenden Trust Company, as Master Trustee.

2. The terms of this Officer's Certificate are in compliance with the requirements of Section 3.10 of the MTI, and it is being delivered together with any opinions, schedules, statements or other documents required in connection with Section 3.10.

3. Pursuant to subsection 3.10(a) of the MTI, attached hereto is a copy of FAHC's audited Financial Statements as of the end of Fiscal Year 2002 accompanied by the opinion of FAHC's independent certified public accountants, Ernst & Young LLP ("E&Y").

4. Pursuant to subsection 3.10(b) of the MTI, attached hereto is a report of E&Y stating FAHC's compliance with the Long-Term Debt Service Coverage Ratio for Fiscal Year 2002.

5. Pursuant to subsection 3.10(b) of the MTI, (i) the Long-Term Debt Service Coverage Ratio for Fiscal Year 2002 is 2.38x, and (ii) to the best of my knowledge, FAHC is not in default in the performance of any covenant contained in the MTI.

6. Also attached hereto are the reports required by subsection 3.10(b) of the MTI from FAHC's independent certified public accountants for Fiscal Years 1993 through 2001. The Long-Term Debt Service Coverage Ratio for Fiscal Years 1993 through 2001 is as follows: FY 2001 - 3.24x; FY 2000 - 3.20x; FY 1999 - 4.31x; FY 1998 -. 81x; FY 1997 - 3.75x; FY 1996 - 3.01x; FY 1995 - 3.57x; FY 1994 - 3.44x; FY1993 - 2.64x.

All terms used herein but not otherwise defined shall have the meanings given to them in the MTI.

Witness my hand this 24th day of February 2003.

Kenneth L. Fisher
Interim Chief Financial Officer
Fletcher Allen Health Care, Inc.

BTV/236027.2

Fletcher Allen Health Care, Inc.

Long Term Debt Service Coverage Ratio

For the Periods Ending:

	FAHC only	Restated FAHC only	FAHC only	FAHC only	FAHC only	FAHC only	FAHC only	FAHC only	MCHV only	MCHV only
	FY 2002	FY 2001	FY 2000	FY 1999	FY 1998	FY 1997	FY 1996	FY 1995	FY 1994	FY 1993
	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept	YE Sept
Income Available for Debt Service:										
Total Operating Revenue and Other support	511,767,000	485,657,000	432,308,000	402,585,000	350,109,000	305,572,000	292,979,750	275,200,193	183,191,677	168,813,981
Less Total Operating Expenses	(497,440,000)	(465,170,000)	(417,027,000)	(393,547,000)	(381,318,000)	(306,137,000)	(294,379,414)	(266,788,661)	(173,530,850)	(165,697,829)
Plus Depreciation and Amortization	26,866,000	24,405,000	23,165,289	21,435,000	19,631,000	14,636,000	13,393,804	11,601,544	8,931,600	7,884,093
Plus Interest Expense	4,349,000	5,221,000	4,800,000	4,088,000	5,442,000	5,064,000	4,947,162	5,391,778	6,463,194	6,164,442
Plus Gifts, Grants and Bequests			-	-					163,067	115,740
Plus Investment Income(1)	(1,006,000)	3,300,000	8,686,167	5,492,000	12,795,000	14,156,000	7,134,085	4,606,323	3,120,898	4,469,105
Plus Investment from Affiliates	3,051,000	2,517,000	2,368,000	(4,461,000)	12,000	(2,382,000)	741,385	(596,277)		
Less Other Expenses	(10,614,000)	(2,693,000)								
	36,973,000	53,237,000	54,300,456	35,592,000	6,671,000	30,909,000	24,816,772	29,414,900	28,339,586	21,749,532
Income Available for Debt Service	36,973,000	53,237,000	54,300,456	35,592,000	6,671,000	30,909,000	24,816,772	29,414,900	28,339,586	21,749,532
Debt Service (2)	15,520,241	16,444,036	16,949,536	8,250,216	8,250,216	8,250,216	8,250,216	8,250,216	8,250,216	8,250,216
Long Term Debt Service Coverage Ratio	2.38	3.24	3.20	4.31	0.81	3.75	3.01	3.57	3.44	2.64
Number of months	12	12	12	12	12	12	12	12	12	12
Covenant: 1.2x for 1993 MTI										
Compliance:	Yes	Yes	Yes	Yes	NO Waiver Granted by FGIC	Yes	Yes	Yes	Yes	Yes

WAIVER

Based on the representations contained in a letter from David Cox, CFO of Fletcher Allen Health Care, Inc. ("Fletcher Allen") to Joseph Campagna dated February 10, 1999, Financial Guaranty Insurance Company agrees to a one-year waiver of the requirement to retain a consultant set out in Section 3.07(b) of the Master Trust Indenture for the Medical Center Hospital of Vermont (1993), predecessor to Fletcher Allen, with respect to Fletcher Allen's failure to meet the Long Term Debt Service Coverage Ratio for fiscal year ended September 30, 1998.

Fletcher Allen Health Care hereby covenant's to provide, until such time as our annual reported Long Term Debt Service Coverage Ratio meets the required level, our quarterly financial statements, a calculation of the Long Term Debt Service Coverage Ratio as of each quarter, a calculation of our days in cash (excluding funds held in trust), and to continue to provide our annual budgets as they are approved.

Dated this 12th day of February, 1999

Financial Guaranty Insurance Company

By: ______________________

Michael Johnston

Appendix C

State Auditor’s Correspondence

..ABETH M. READY
STATE AUDITOR

STATE OF VERMONT

OFFICE OF THE STATE AUDITOR
132 STATE STREET
MONTPELIER, VERMONT 05633-5101

August 7, 2002

Malcolm S. Rode, Executive Director
Vermont Educational & Health Buildings Financing Agency
133 State Street, 2nd Floor
Montpelier, VT 05633-6200

Dear Mr. Rode:

Thank you for agreeing to meet with me and members of my staff on Thursday, August 8th.

The purpose of the meeting is for my Office to gain an understanding of Vermont Educational & Health Buildings Financing Agency's (the Agency) operations in financing health care facilities. My Office is considering conducting a special review of the Agency's internal controls over activities associated with the financing of health care facilities and with the processes and procedures employed to carry out the statutory functions of the Agency. This meeting and the information gathered by my Office is part of a preliminary assessment to determine if a special review will be conducted.

As part of our preliminary assessment process, and pursuant to my Office's authority outlined in 32 V.S.A § 163 (1) and 16 V.S.A. § 3855 (c), and pursuant to 1 V.S.A. §§ 315 through 318, please make available the following documents for our review:

1. All applications, correspondence, Certificates of Need, Official Statements and board minutes for all bond offerings related to Fletcher Allen Health Care for calendar years 1991 through 2001.

2. All applications, correspondence, Certificate of need and Official Statements for all bond offerings for all other health care facilities for calendar years 1996 through 2001.

I realize this may be a voluminous information request. If necessary we can review documents and identify those we would like copied and provide staff support for copying if necessary.

Thank you again for your cooperation. I look forward to our meeting.

Sincerely,

Elizabeth M. Ready
State Auditor

State Auditor & Deputy
(802) 828-2281
e-mail: auditor@sao.state.vt.us

Fax: (802) 828-2198
Website: www.state.vt.us/sao

Follow-Up Questions Sent VIA E-mail from State Auditor’s Office to the Agency on August 14, 2003

Did Fletcher Allen provide proof of a Certificate of Need for the various capital expenditures they paid for with proceeds from the Series 2000A and 2000B bonds?

The Bond Counsel for the Agency has reviewed the requisition forms and determined that nothing looked as if it is related to the garage. When was this analysis completed and how was it delivered to the Agency - verbally or in writing? Does the Agency have a policy and procedures manual related to the review of requisition forms?

Did Fletcher Allen notify the Agency about changes in the project’s design, or to the CON for the project? If so, how and when? Did the Agency, or its counsel, ask any questions about changes to the overall project?

Did the Agency’s bond counsel, at the time of closing or since the bonds were issued, give any guidance to Fletcher Allen or to the Agency in writing regarding the financing of the underground parking garage? Verbally? What documentation of this advice exists?

Did the Agency’s Board of Trustees discuss changes to the project? Does the Board track changes to any project it issues bonds for? Does the Agency have a conflict of interest policy for its board members?

How are the covenants in the Tax Certificate and Trust Agreements enforced? Has one ever been enforced? What steps would the Agency take if it knew an entity’s billings were in violation of the agreement? Would the Agency deny the request, and if it did what are the steps taken and who is notified of the violation? Has the Agency ever denied a request?

Whose responsibility is it to enforce the agreements?

Does any signatory to the bond agreements - such as the Agency, the Master Trustee or the Bond Insurer - track construction spending against the agreed-to bond expenditure timeline?

Vermont Educational and Health Buildings Financing Agency

Malcolm S. Rode
Executive Director

August 23, 2002

Ms. Elizabeth M. Ready
State Auditor
Office of the State Auditor
132 State Street
Montpelier, Vermont 05633-5101

Re: Vermont Educational and Health Buildings Financing Agency Hospital Revenue Bonds (Fletcher Allen Health Care Project) Series 2000A and Series 2000B

Dear Ms. Ready:

I am writing in response to certain questions your office has asked on August 14, 2002, regarding Fletcher Allen Health Care's 2000 bond financing. Before responding to your specific questions I would like to summarize briefly the purpose of the Agency in facilitating the financing of capital projects by non-profit healthcare and educational institutions in Vermont.

The Agency was created in 1966 as a public instrumentality of the State. The Agency functions as the statewide issuer of bonds and notes, providing access to the capital markets for eligible educational and healthcare institutions within the State. Eligible healthcare institutions include any nonprofit hospital; any nonprofit institution whose purpose is devoted primarily to the maintenance and operation of diagnostic and therapeutic facilities for medical, surgical or psychiatric care of ambulatory patients; any nonprofit licensed nursing home; any nonprofit assisted living facility, nonprofit continuing care retirement facility, nonprofit residential care facility or similar nonprofit facility for the continuing care of the elderly or the infirm, provided that such facility is owned by or under common ownership with an otherwise eligible institution; and in all such cases for which the Department of Banking, Insurance, Securities and Health Care Administration, if required, has issued a certificate of need.

Current federal tax laws allow the Agency, on behalf of an eligible institution, to issue bonds or notes on a tax-exempt basis. The Agency in turn loans the proceeds to the borrowing institution. The interest rates on each transaction are set in the marketplace by the buyers of the bonds based on their evaluation of the creditworthiness of the respective borrower or credit enhancement provider.

133 State Street, 2nd Floor, P.O. Box 564, Montpelier, Vermont 05601-0564
Telephone (802) 223-2717 - Toll Free (800) 894-2717 (In VT Only) - Fax: (802) 229-4709 - Email: msrode@attglobal.net

Bonds and notes of the Agency issued for a specific institution are repaid solely from funds generated by the borrowing institution and are secured entirely with collateral provided by the borrower or through additional credit enhancement. Collateral may include a revenue pledge, reserve funds, perfected security interests in real or personal property and various forms of covenants. Credit enhancement could come in the form of bond insurance or letters of credit from commercial banks. It is important to note that the Agency is not a regulatory agency. The Agency provides access to the capital markets, but it is not itself responsible for the repayment of its bonds nor does it enhance the creditworthiness of its bonds. In addition, the State of Vermont does not provide any pledge or support to the payment of debt service on any of the Agency's bonds or notes.

As of December 31, 2002, the Agency had issued 101 series of bonds, including refundings, for Vermont's healthcare and educational institutions totaling $1.071 billion.

As for your specific questions related to Fletcher Allen:

1. *Did Fletcher Allen provide proof of a Certificate of Need for the various capital expenditures they paid for with proceeds from the Series 2000A and 2000B bonds?*

   The Agency's enabling legislation requires, for healthcare projects, that a CON, if required, be issued as a condition procedent to the Agency's issuance of bonds. Fletcher Allen had received CON approval on April 12, 1999, for the Ambulatory Care Facility Project (as defined in the official statements for its Series 2000 bonds). The Trust Agreements pursuant to which those bonds were issued create Construction Funds into which bond proceeds were deposited and held in trust by Chittenden Trust Company, the Bond Trustee. The Trust Agreements establish a requisition procedure pursuant to which Fletcher Allen may withdraw funds for the payment of project costs. Each requisition requires Fletcher Allen to evidence compliance with CON requirements when withdrawing funds. The Trust Agreements permit both the Bond Trustee and the Agency to rely on the information in the requisitions submitted by Fletcher Allen.

2. *The Bond Counsel for the Agency has reviewed the requisition forms and determined that nothing looked as if it is related to the garage. When was this analysis completed and how was it delivered to the Agency – verbally or in writing? Does the Agency have a policy and procedures manual related to the review of requisition forms?*

   The Agency's Bond Counsel is not involved in the review of construction fund requisitions as they are submitted. They were not furnished with copies of the Fletcher Allen requisitions until

August of 2002. During their preliminary review they had pointed out that certain specific items, representing approximately $^{2}/_{10}$ of 1% of the total disbursements, did refer to "architectural-garage". This analysis was only delivered verbally to the Agency. The Agency does not have a policy and procedures manual related to the review of requisition forms. The Agency's financing documents permit it to rely on the information in the requisitions submitted and certified by borrowers.

3. *Did Fletcher Allen notify the Agency about changes in the project's design, or to the CON for the project? If so, how and when? Did the Agency, or its counsel, ask any questions about changes to the overall project?*

In the second half of May 2000, Fletcher Allen notified the Agency of certain changes in the scope of the Ambulatory Care Project. Fletcher Allen furnished to the Agency a copy of a May 17, 2000 letter from David Demers, the then Fletcher Allen Vice President of Planning and Business Development, to Susan Gretkowski, the Deputy Commissioner of BISHCA. That letter compared and contrasted the project as approved versus its current design. The Agency forwarded that letter by fax to its Bond Counsel on May 30, 2000.

With regard to the parking garage the May 17 letter stated:

> The cost of constructing the garage is removed from the CON. A third party will be found to construct and own the facility, recouping their investment by charging a nominal fee for parking. This will eliminate the need for spending patient care dollars on a non-patient care resource.

Bond Counsel advised the Agency and Fletcher Allen that removing the garage from the CON would mean that no moneys in the Construction Funds could be used for the garage. Removing the parking garage from the CON also required an analysis by Bond Counsel, in order to maintain the tax-exempt status of the Series 2000 bonds, to determine if the remaining CON project was sufficiently large to absorb the Construction Fund moneys. Bond Counsel had discussions with Fletcher Allen representatives, including Rod Whitney, in the first half of June 2000 and did then conclude that the remaining CON project would be sufficiently large.

4. *Did the Agency's bond counsel, at the time of closing or since the bonds were issued, give any guidance to Fletcher Allen to the Agency in writing regarding the financing of the underground parking garage? Verbally? What documentation of this advice exists?*

To the best knowledge of the Agency, the only time the Agency's Bond Counsel gave any guidance to Fletcher Allen or the Agency regarding the financing of the parking garage after the bond closing involved responding in the summer of 2000 to two or three telephone calls of David Sylvester of Down, Rachlin & Martin, counsel to Fletcher Allen (on at least one of which calls James Scibetta from Shattuck Hammond Partners, Fletcher Allen's financial advisor, was also present). On those calls Mr. Sylvester only inquired about the interpretation of certain financial covenants in Fletcher Allen's Master Trust Indenture in the event of an off-balance sheet financing of the parking garage. During such calls Bond Counsel did suggest that Fletcher Allen also discuss such off-balance sheet financing with its bond insurer and the bond rating agencies. The advice was verbal. To the best knowledge of the Agency, no documentation of this advice exists.

5. *Did the Agency's Board of Trustees discuss changes to the project? Does the Board track changes to any project it issues bonds for? Does the Agency have a conflict of interest policy for its board members?*

The Agency's Board has not discussed changes to the Fletcher Allen project since the Series 2000 bonds were issued. The Board is not required to track changes to the projects for which the Agency issues bonds. The Agency's bond documents only permit a borrower to finance the specific project described in those documents. Those documents include a mechanism by which the borrower may, subject to a number of conditions, modify the project after the bonds are issued. It is the responsibility of the borrower to initiate that process.

The Agency actively monitors potential conflicts of interest between a proposed borrower and its board members. Any board member with such a conflict would recuse himself or herself from any vote in such a situation. All members appointed by the Governor are made aware of the State's conflict of interest policy upon appointment and reappointment.

6. *How are the convenants in the Tax Certificate and Trust Agreements enforced? Has one ever been enforced? What steps would the Agency take if it knew an entity's billings were in violation of the agreement? Would the Agency deny the request, and if it did what are the steps taken and who is notified of the violation? Has the Agency ever denied a request?*

7. *Whose responsibility is it to enforce the agreements?*

It is the responsibility of the Master Trustee to enforce the provisions of the Master Trust Indenture and it is, in turn, the responsibility of the Bond Trustee to enforce the provisions of the Trust Agreements and the Loan Agreements. The Agency, in connection with any trusteed financing, assigns to the Bond Trustee all of its right, title and interest in the related Loan Agreement, with the exception of the Agency's rights to be indemnified, to be paid its administrative fees, to receive notices and to grant certain consents and approvals. Those assigned rights include all enforcement rights.

It is also important to understand the nature of financing documents generally, including those of the Agency, as it relates to enforcement. Financing documents impose numerous affirmative and negative covenants on borrowers over and above the core monetary obligation to repay the borrowed funds with interest. Such covenants often include limitations on other borrowings, transfers of assets, creation of liens, mergers and consolidations and, in all tax-exempt financings, a covenant to maintain the tax-exempt status of interest on the borrowed funds. Certain covenants, such as the incurrence of certain permitted indebtedness, require that evidence of compliance be submitted to the trustee at the time of the proposed action. In addition, the Agency's financing documents require the borrowers to certify annually as to the absence of covenant defaults (or, if such defaults exist, what remedial action is being taken). Compliance with covenants, however, always remains the responsibility of the borrower. Finally, covenant defaults, other than the covenant to repay the borrowed money with interest, do not ripen in to Events of Default, permitting the trustee to exercise remedies, until after notice and an opportunity to cure have been given to the borrower.

Should the Agency become aware of a covenant violation, it would in the first instance notify the related Bond Trustee and borrower.

I assume the reference to "billings" in your question refers to requisitions. As with other covenant violations, the Agency would first notify the Bond Trustee and the borrower. The Agency would be obliged to deny the request pending a resolution of the alleged violation. The Agency has on occasion requested clarification of information in requisitions submitted to it for approval. The Agency has always been able to resolve such issues to its satisfaction.

8. *Does any signatory to the bond agreements, such as the Agency, the Master Trustee or the Bond Insurer track construction spending against the agreed-to bond expenditure timeline?*

The bond agreements do not require the borrower to agree to a set expenditure timeline. Instead, the borrower covenants to complete its project "with all reasonable dispatch". Federal tax law also requires that a borrower have a reasonable expectation as of the date of issuance that it will expend 85% of its construction fund proceeds within three, or upon the satisfaction of certain additional conditions, five years. Fletcher Allen qualified for the longer five-year period in connection with the Series 2000 bonds.

We are happy to assist you in this matter and to help you understand better the role of the Agency in providing access to the tax-exempt credit markets to its eligible borrowers.

Very truly yours,

Malcolm S. Rode

Malcolm S. Rode

Executive Director

Fletcher Allen
HEALTH CARE

In alliance with
The University of Vermont

RECEIVED
DEC 0 2 2002
VERMONT
STATE AUDITOR

December 2, 2002

VIA HAND DELIVERY

Malcolm S. Rode, Executive Director
Vermont Educational and Health Buildings Financing Agency
133 State Street, 2nd Floor
P.O. Box 564
Montpelier, Vermont 05601-0564

Re: Fletcher Allen Health Care, Inc.: Request for Information

Dear Mr. Rode:

Please find enclosed with this letter the supporting documentation for each of the twenty (20) requisitions submitted to date by Fletcher Allen in connection with the $100 Million Hospital Revenue Bonds, Series 2000A, dated March 1, 2000, and the $50 Million Variable Rate Hospital Revenue Bonds, Series 2000B, dated March 28, 2000, issued by your agency. The twenty (20) requisitions, totaling $53,910,111.13, cover the time period between August, 2000 and September, 2002.

We are also enclosing a new requisition, number #21, dated November 2002, in the total amount of $467,771.96.

We have compiled the supporting documentation for each of the twenty-one (21) requisitions in binders for ease of reference. There are twenty-seven (27) binders enclosed with this letter (some requisitions required multiple binders). Fletcher Allen will submit all future requisitions in this manner.

The enclosed binders should contain sufficient detail to answer the questions raised by the Vermont State Auditor in her letter to you dated August 19, 2002. We apologize for the delay in providing your office with the enclosed materials. It took several weeks for Fletcher Allen staff to compile and organize the binders. We are confident that the binders accurately detail the $53,910,111.13 in bond proceeds that we have received to date. To the extent that you have further questions, please feel free to contact me.

For your benefit and the benefit of the Vermont State Auditor, it might be helpful to provide some additional information on the requisition process to date:

FINANCE DEPARTMENT 802.847.1300 Fax 802.847.8415
MAILING P.O. Box 1870 Burlington, VT 05402-1870 • SHIPPING 208 Hurricane Lane Williston, VT 05495

The letter from the Vermont State Auditor to you dated August 19, 2002, states that "tax-exempt bond proceeds could not be used to build a privately-held parking garage." The Vermont State Auditor is apparently interested in determining whether Fletcher Allen has used the bond proceeds to pay for the construction of the underground parking garage (the "Parking Garage") currently being developed on Fletcher Allen's campus by CSL Leasing, Inc. ("CSL"), a subsidiary of J.P. Morgan Chase.

Based upon our intensive review, there are two issues to note in this connection: (i) architectural and design fees directly related to the Parking Garage ($357,309.12) that were inadvertently included in the early requisitions for bond proceeds, and (ii) early requisitions that included certain fees and expenses (*i.e.*, design, permits, insurance) related to the entire construction project on the MCHV Campus that did not distinguish between the Parking Garage and the Renaissance Project,[1] a portion of which fees and expenses ($674,793.61) were later specifically allocated to the Parking Garage in May 2002.

These issues arose, in large measure, because the Renaissance Project and the Parking Garage were originally conceived as a single overall project— from both the financing and construction perspectives. The transaction with CSL, however, created a separate financing structure for the Parking Garage. The earliest requisitions for bond proceeds in late 2000 and early 2001 did not adequately reflect this change.

As described below, Fletcher Allen has credited these amounts, totaling $1,032,102.73, back to the agency in Requisition # 20 and Requisition # 21.

While these issues are largely historical in nature, we have put in place internal controls that will monitor the construction invoices being processed on a daily basis to ensure that these issues do not re-occur in the future.

Parking Garage: Architectural and Design Fees

Fletcher Allen submitted three (3) requisitions that inadvertently included ten (10) invoices for architectural and design fees directly relating to the Parking Garage, totaling $357,309.12.

Specifically, (i) Requisition # 1, paid on August 17, 2000, included seven (7) of the invoices, totaling $167,259.31, (ii) Requisition # 2, paid on October 23, 2000, included

[1] As used in this letter, we define the "Renaissance Project" as the entire construction project currently underway on the MCHV Campus, including the ambulatory care facility, the central plant, the Education Center, the birthing center, etc., but excluding the Parking Garage.

two (2) of the invoices, totaling \$98,971.69, and (iii) Requisition # 3, paid on February 21, 2001, included one (1) of the invoices, totaling \$91,078.12.

Fletcher Allen included these ten (10) invoices, among the thousands of invoices paid out of bond proceeds, through administrative error. At the time these requisitions were submitted, between August 2000 and February 2001, Fletcher Allen had already decided to utilize a third party to develop, and pay for, the Parking Garage. Therefore, Fletcher Allen should not have included the ten (10) invoices for payment out of the bond proceeds.

In this regard, however, we note that: (i) the ten (10) invoices were included in the earliest requisitions dating back to August 2000, well before Fletcher Allen had closed the transaction for the Parking Garage with CSL, and (ii) since February 2001 (the date of Requisition # 3), none of Fletcher Allen's requisitions have included invoices directly related to the Parking Garage.

In September 2001, in preparation for the closing with CSL, Fletcher Allen reviewed the requisitions submitted to your agency, and created a receivable in favor of Fletcher Allen from CSL, which included the \$357,309.12. In addition, Fletcher Allen provided a "credit" back to the agency in the amount of the ten (10) invoices (\$357,309.12) in Requisition #10, paid in December 2001. In other words, Fletcher Allen simply withheld, and did not submit to the agency, various invoices for the Renaissance Project totaling at least \$357,309.12 that would have otherwise been allowable under the tax-exempt bond rules (hence, the "credit"). Therefore, Fletcher Allen has long since remedied its earlier administrative error concerning the ten (10) invoices.

However, as we have discussed, this earlier "credit" is not reflected in the formal paperwork for Requisition #10. For optimum transparency, Fletcher Allen has, with your agreement, formally "credited" back to the agency an additional \$357,309.12 through recent requisitions. Specifically, Fletcher Allen credited the agency with \$300,934.23 in Requisition # 20 dated September 2002.[2] This amount reflected a "credit" for nine (9) of the ten (10) invoices. The last remaining invoice, in the amount of \$56,374.89, is being credited back to the agency in Requisition # 21, enclosed.

[2] Requisition # 20 in September 2002 also credited the agency with \$565,850.41 for nine (9) journal entries included in Requisition # 18 dated July 2002. These journal entries relate to the Renaissance Project, and are completely unrelated to the Parking Garage. Nevertheless, in an abundance of caution, we decided to also credit these journal entries back to the agency in September because we did not find sufficient supporting documentation for them at that time. We have since located the necessary documentation, and we intend to submit these costs for payment in a future requisition.

Fletcher Allen has now credited the same $357,309.12 back to your agency twice— once in December 2001 (Requisition # 10) and again in September/November 2002 (Requisitions ## 20 and 21).

Parking Garage: Allocable Fees and Expenses

Fletcher Allen has separate construction contracts with Macomber/Barton Malow ("MBM") for the construction of the Parking Garage and the construction of the Renaissance Project. Fletcher Allen can easily track the separate "hard" construction costs of the Parking Garage and the Renaissance Project.

In contrast, many of the "soft" costs for the Renaissance Project and the Parking Garage are billed to Fletcher Allen or MBM on a single, combined invoice. In these instances, Fletcher Allen must allocate the invoice between the Parking Garage (for which Fletcher Allen may not use bond proceeds) and the Renaissance Project (for which Fletcher Allen may use bond proceeds). Fletcher Allen developed allocation methodologies for these "soft" costs (*i.e.*, architectural/design, permits, insurance) when we closed the transaction with CSL.

As detailed in Requisition # 21, Fletcher Allen's earliest requisitions (## 1 through 4) included 82 invoices that should have been, but were not, allocated between the Parking Garage and the Renaissance Project. The failure to allocate the invoices is not surprising since these requisitions were, with 2 exceptions,[3] submitted prior to the closing with CSL.

In May 2002, as part of a general reclassification of the costs for the entire construction project, we reviewed the invoices and applied the allocation methodologies. This review resulted in an allocation of the 82 invoices between the Parking Garage and the Renaissance Project, with a total of $674,793.61 being assigned to the Parking Garage. The $674,793.61 is included within the budget for the Parking Garage approved by CSL.

In Requisition # 21, we have "credited" back to the agency the full $674,793.61.

* * * * * * * *

As we understand it, you have confirmed with your bond counsel that the corrective approach set forth above is appropriate, and that there are no issues relative to Fletcher Allen's compliance with the laws and regulations applicable to tax-exempt bond

[3] Requisition # 12 included $620.00 and Requisition # 16 included $97,276.30 that should have been allocated to the Parking Garage.

issuances. We apologize for any confusion that these issues may have generated. We do not want to leave any room for doubt as to Fletcher Allen's commitment to fully complying with our obligations to your agency and under applicable laws and regulations.

Please let me know if you have any questions. Thank you.

Very truly yours,

Roderick Whitney

Roderick Whitney
Treasury Director

ELIZABETH M. READY
STATE AUDITOR

STATE OF VERMONT

OFFICE OF THE STATE AUDITOR
132 STATE STREET
MONTPELIER, VERMONT 05633-5101

December 5, 2002

Malcolm S. Rode, Executive Director
Vermont Educational and Health Buildings Financing Agency
133 State Street, 2nd Floor
Montpelier, VT 05601-0564

Dear Malcolm:

I am writing to thank you for your providing our Office with the documents that support Fletcher Allen Health Care's (FAHC) spending of tax-exempt bond proceeds.

Our Office has begun to review these documents, but we believe some information is missing and are asking that further documentation be provided.

First, in Fletcher Allen Health Care's December 2, 2002 letter to the Vermont Educational and Health Buildings Financing Agency, they said, "As we understand it, you have confirmed with your bond counsel that the corrective approach set forth above is appropriate, and that there are no issues relative to Fletcher Allen's compliance with the laws and regulations applicable to tax-exempt bond issuances."

Our Office would like to review the correspondence from VEHBFA's bond counsel outlining its opinion on the appropriateness of FAHC's corrective actions, as well as any other correspondence, including e-mails, related to these issues of compliance.

Second, in its December 2, 2002 letter, FAHC also noted that it had provided the supporting documentation for each of the requisitions in connection with the Series 2000A and Series 2000B Hospital Variable Rate Revenue Bonds issued by VEHBFA.

Upon review of the binders, our Office did not find any supporting documentation for any of the Series 2000B requisitions. You indicated to us on December 3, 2002 that you would contact FAHC and have them provide this documentation. Please let us know when you expect this supporting documentation to arrive at your office.

Finally, from our initial review it appears that supporting documentation was not provided for the first requisition of project-related costs (Requisition 1, dated March 29, 2000) submitted by FAHC for payment from the Series 2000A bonds. This amount totaled $2.5 million for "Network/PC Rollout (computers)." Have we overlooked something, and if not when will this documentation be made available?

A second requisition for project-related costs (also labeled Requisition 1, dated August 17, 2000) totaling more than $5.7 million for project-related costs from the Series 2000A bonds does appear to have supporting documentation.

We would like to complete our review in a timely fashion in order to offer some thoughtful recommendations about improving controls. Please let us know when these documents will be available for our Office to review. Thank you for your continued cooperation and assistance.

Sincerely,

Michael J. Clasen
Deputy State Auditor

ELIZABETH M. READY
STATE AUDITOR

STATE OF VERMONT

OFFICE OF THE STATE AUDITOR
132 STATE STREET
MONTPELIER, VERMONT 05633-5101

December 13, 2002

Malcolm S. Rode, Executive Director
Vermont Educational & Health Buildings Financing Agency
133 State Street, 2nd Floor
Montpelier, VT 05633-6200

Dear Mr. Rode:

I am writing to follow-up on our telephone conversation yesterday where we discussed the following issues relating to my Office's review of the documents that support Fletcher Allen Health Care's (FAHC) spending of tax-exempt bond proceeds.

1. A number of the early requisitions included garage-related spending paid for with tax-exempt bond proceeds, and FAHC notes it is re-allocating $1,032,102.73 to the Construction Fund. The funds appear to be re-allocated on a flat percentage rather than based on exact, detailed expenses related to the parking garage. You acknowledged in our conversation that garage related expenditures were in fact re-allocated to the Construction Fund on a prorated basis.

   What is the basis of the methodology that was used to reallocate garage related expenditures to the Construction Fund?

2. We noted that while we do have copies of FAHC's Officer Certificate included in their quarterly Financial Disclosure Statements, they appear to fall short of the "Certificate of No Default" required annually and described below.

   Section 3.10. **Filing of Financial Statements, Certificate of No Default and Other Information**, of the Master Indenture requires the following:

   "(b) Within thirty (30) days after receipt of the audit report mentioned above but in no event later than one hundred twenty (120) days after the end of each Fiscal Year, file with the Master Trustee and with each Holder who may have so requested, an Officer's Certificate and a report of independent certified public accountants stating the Long-Term Debt Service Coverage Ratio for the Fiscal year and stating whether, to the best knowledge of the signers, any Member of the Obligated Group is in default in the performance of any covenant contained in this Indenture, and, if so, specifying each such default of which the signers may have knowledge and whether each such default has been corrected. If any default has not been remedied then such report of independent certified public accountants, to the best knowledge of the signers, shall identify what, if any corrective action will be taken to cure such default."

In the opinion of Bond Counsel, are these Disclosure Statements adequate? If not, have the required "Certificates of No Default" been submitted annually as required? Please forward a copy of any opinion on this subject.

3. During our conversation you stated you would consult with Bond Counsel to determine if the reallocation of garage related expenditures to the Construction Fund constitutes and "Event of Default" as described below.

   Article VI, Section 6.06 of the Loan Agreement between FAHC and VEHBFA dated February 1, 2000 states that "The Agency and Hospital severally covenant that they will at the expense of the hospital, promptly give to the Bond Trustee written notice of any Event of Default under this agreement of which they shall have actual knowledge or written notice, but the Agency shall not be liable for failing to give such notice."

   According to Article VIII, Section 801(c) of the Trust Agreement between VEHBFA and Chittenden Trust Company dated February 1, 2000, an "Event of Default" is a broad term that includes "default in the due and punctual performance of any other of the covenants, conditions, agreements and provisions contained in this Trust Agreement or any agreement supplemental hereto and thereto and such default shall continue for thirty (30) days or such further time as may be granted in writing by the bond Trustee after receipt by the Agency of a written notice from the Bond Trustee specifying such default and requiring the same to be remedied…".

Thank you for your continued cooperation. Please let me know when we can expect a response to our questions on these issues.

Sincerely,

Elizabeth M. Ready
State Auditor

Appendix D

Timeline of Key Events Related to the Renaissance Project

Key Events Related to the Use of Tax-Exempt Bond Proceeds to finance the Renaissance Project

Prepared by the Office of the State Auditor, February 2003

1999

March 17: Fletcher Allen Health Care (FAHC) officials meet with representatives of the Vermont Educational and Health Buildings Financing Agency (Agency) to establish a working group to finance pending construction project that is expected to receive a Certificate of Need (CON) from the State.

April 12: Original CON approved by the Department of Banking, Insurance, Securities and Health Care Administration (BISHCA), including $16.4 million for a parking garage, after hearings held before the Public Oversight Commission (POC).

August 27: The Agency agrees to issue bonds to fund construction of FAHC's project.

September 21: The Agency holds public hearing on the issuance of bonds related to Fletcher Allen's construction project. No one from the public attends.

2000

February 28: $150 million in bonds, two series, officially priced by Salomon Smith Barney.

March 5: Act 250 permit issued.

March 28: Bond issues close.

March 9: FAHC presents overview of design review changes to the POC; the parking garage is still part of the CON.

May 17: FAHC sends a "white paper" to BISHCA to announce changes to its CON. FAHC says it is removing the garage and changing the project's overall design and scope.

June: FAHC counsel has discussions with the Agency and its bond counsel about removing the parking garage. FAHC is told verbally that it cannot use bond proceeds to finance the construction of the private parking garage.

July 12: FAHC presentation regarding design review changes to POC, including the removal of the parking garage from the CON because a third party is being sought to finance, build and own it.

December 12: BISHCA denies party status to Business Review Services, citing any delay could place the tax-exempt status of the bonds used to finance the Renaissance Project.

December 15: POC recommends approval of amended CON.

2001

March 2: BISHCA Commissioner approves amended CON for $173.4 million.

April: Groundbreaking of Renaissance Project.

June – December: FAHC is reimbursed with $11.8 million in tax-exempt bond proceeds for work that is related to site excavation, foundation construction and building demolition that, in part, supports the private parking garage. This money is also being used to pay for items that FAHC now admits it hid from regulators – including building demolition and some site excavation.

July 16: FAHC Board of Trustees' Executive Committee meets to approve garage financing.

July 19: FAHC enters into financing agreement with JP Morgan Chase to build the underground parking garage.

August 30: FAHC pays (with tax-exempt bond proceeds) more than $52,000 to the City of Burlington for a zoning permit. This permit is for the site excavation and construction of foundations of all proposed buildings – including the private parking garage.

September 7: Fletcher Allen enters into a Garage Parcel Ground Lease with CSL Leasing (a subsidiary of JP Morgan Chase).

October: Excavation for Ambulatory Care Center and private parking garage begins.

October 31: FAHC files design development report with BISHCA.

December 3: FAHC pays (with tax-exempt bond proceeds) more than $129,000 for a City of Burlington zoning permit related to increased costs of the total construction project; this addition includes the costs associated with the private parking garage.

December 10: FAHC files status report regarding the conditions of the amended CON with BISHCA.

December 14: FAHC pays (with tax-exempt bond proceeds) $42,000 for a City of Burlington building permit to put in place a below-grade foundation that will support, in part, the private parking garage.

December 14: BISHCA requests documents related to the parking garage transaction.

December 18: FAHC responds to BISHCA request.

December 20: BISHCA issues subpoena to FAHC in order to receive documents.

2002

January: FAHC responds to BISHCA's subpoena.

March – April: FAHC spends more than $15.8 million on excavation and foundation work related to the Renaissance Project. It is unclear if any of the tax-exempt bonds were used during this time to complete work on the parking garage.

April: Excavation of the Ambulatory Care Center is completed.

April 3: Former FAHC CFO David Cox testifies, under oath, before BISHCA counsel in response to earlier subpoena.

June 21: FAHC agrees to pay a BISHCA fine of $320,000 for not applying for CON for the private parking garage.

July 15: BISHCA Commissioner issues CON for private parking garage, after determining that it is being built on behalf of FAHC and should have been included in the total price associated with the CON.

August 19: State Auditor's Office requests supporting documentation from the Agency to demonstrate how Fletcher Allen had used tax-exempt bond proceeds.

December 2: FAHC provides 27, three-ring binders of documentation to the Agency and the State Auditor's Office.

(*Sources: Fletcher Allen Health Care, the Department of Banking, Insurance, Securities and Health Care Administration, the Vermont Educational and Health Buildings Financing Agency and staff research*)

To obtain additional copies of this report contact:

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State Auditor

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This report is also available on our website:
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