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From the Desk of R. Lewis Dark...

THE DARK REPORT

RELIABLE INTELLIGENCE, EXCLUSIVELY FOR MEDICAL LAB CEOs / COOs / CFOs

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

Clinical Lab Industry A Mature Marketplace

In our role as the lab industry's management "futurist" we spend a lot of time pondering the meaning of individual events in cities throughout the United States. One common trait of successful organizations is their ability to accurately translate such events into a strategic plan which correctly predicts the future... and positions their company to be at the right place, at the right time, with the right product.

During the last few years, changes to the clinical laboratory industry were exponential. Public laboratories went from being the darlings of Wall Street to the brink of financial disaster. Medicare and Medicaid transformed from acceptably profitable reimbursement programs into burdensome administrative nightmares. Hospital mergers and acquisitions upended traditional regional healthcare arrangements. Managed care, and its growing emphasis on capitation, placed all laboratories under extreme pressure to slash costs and revamp operations.

In times of radical change, what advice can we give to clinical laboratory executives? What future is predicted by our crystal ball? No single answer emerges, but there is one piece of sage advice. All evidence tells us that the clinical laboratory industry has entered a mature market phase. This means there will be no rapid growth in the volume of testing performed within the United States. Any laboratory which expands specimen volume will do it at the expense of a competing laboratory.

Thus, our advice is that laboratory executives should base their laboratory's strategic business plan on an "added-value" proposition. We believe that success lies in emphasizing services and testing which laboratory clients find valuable, even compelling. This is more important than any single-minded focus on cutting costs.

Quest Diagnostics Incorporated, in joining their Phoenix laboratory with **Sonora Laboratory Sciences**, recognizes the truth of the mature marketplace. The strategic plan for the Atlanta reference laboratory joint venture between **Columbia** and **MDS/Autolab** does not, since it calls for outreach sales to help fill excess capacity at the newly constructed laboratory. **UroCor, Inc.** of Oklahoma City is a disease management company/diagnostic laboratory which understands the importance of value-added services as a vehicle for growth in a mature market. *(See TDR, June 23, 1997.)* We expect the accuracy of our advice will be confirmed as the marketplace responds to the strategic plans of UroCor as well as the Phoenix and Atlanta joint ventures during the next two years. **TDR**

Quest Diagnostics, Sonora Join Phoenix Operations

Joint venture between the two laboratories forms basis for new organizational model

CEO SUMMARY: When Quest Diagnostics Incorporated and Sonora Laboratory Sciences announced their joint venture, it confirmed that Quest Diagnostics is the first of the national laboratories to begin serious restructuring of its national network of regional laboratories. Such restructuring will include local partners. Expect similar arrangements to occur in other cities during the next two years.

PHOENIX GAINS a new laboratory competitor when **Quest Diagnostics Incorporated** and **Sonora Laboratory Sciences** combine operations to create their new joint venture.

In a press release issued July 9, the companies announced that the two laboratories would merge into one service organization. The venture will be called **Sonora Quest Laboratories, LLC**. It formally begins operations on September 1, 1997.

The announcement that Quest and Sonora would combine laboratories is a key event in the rapid evolution of the clinical laboratory marketplace. It marks the first time in recent years that the laboratory of an integrated hospital system and a national laboratory are pooling resources in a shared equity venture.

This joint venture will offer laboratory services throughout the state of Arizona. It validates THE DARK REPORT's prediction that regional laboratory systems will emerge as the dominant form of laboratory services in metropolitan areas everywhere in the country. Such regional lab systems are designed to offer testing across a specific geographical area served by the major managed care plans in that city.

In fact, geographical service enhancements gained by both laboratories was one reason behind the merger. "Each laboratory was strong in different regions of Arizona," stated Earl C. Buck, Chief Executive Officer of **Laboratory Sciences of Arizona**. "Our combined network of draw sites, stat labs and

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courier services give us comprehensive reach throughout the state.

"Also, we now have improved access to managed care patients," he continued. "Each laboratory held contracts with different managed care plans. As the two laboratories combine, it will permit us to serve an extended range of managed care programs."

"This joint venture is driven by the mutual appreciation of both partners for the value which an integrated healthcare system brings to the community."

-Earl C. Buck

Earl Buck will be the Chief Executive Officer of the combined laboratory. Judy Burgess, now Vice President and General Manager of Quest Diagnostics of Arizona, will become Chief Operating Officer at the joint venture. Employees of Quest will become employees of the integrated laboratory.

The joint venture will be chartered as a limited liability company (LLC). There will be seven members on the Board of Directors. "It will be equal representation on the Board," explained Buck. "Sonora and Quest each have three directors. A seventh board member is the medical director of the joint venture. He provides input on medical issues relevant to the organization."

"One strategic goal for Quest is to align with strong partners who share our values," stated Judy Burgess, now COO of Sonora Quest Laboratories. "The **Samaritan Health System**, with its values and management objectives, is a good fit with Quest. Both partners are excited about the opportunities opened up by this joint venture."

It is not surprising that Phoenix is the first market to see a shared equity joint venture between a local integrated healthcare system and a national laboratory. During the last ten years, Phoenix has consistently been one of the most aggressive and competitive markets for managed care.

Regular readers of THE DARK REPORT know that capitated laboratory service contracts popped up in Phoenix as early as 1987. *(See TDR, December 26, 1995, January 15, 1996.)* By the early 1990s, most physician offices used multiple laboratories because of various managed care contracting arrangements.

Three Dominant Labs

During this time, three commercial laboratories emerged as dominant in the Phoenix marketplace. **National Health Laboratories** (now **Laboratory Corporation of America**), **Damon** (now Quest) and Sonora Laboratory Sciences. **SmithKline Beecham Clinical Laboratories** never achieved the critical mass in Phoenix necessary to support a significant laboratory organization. Currently the bulk of its business in the area comes from its exclusive national contract with **Cigna Healthcare**.

Sonora Laboratory Sciences was an outreach laboratory operated as a for-profit division of Samaritan Health Systems. Samaritan is a major healthcare provider in Phoenix, with six acute care hospitals. Its healthcare plan, **HealthPartners of Arizona**, covers 425,000 lives and is the second largest plan in Arizona.

Second Consolidation

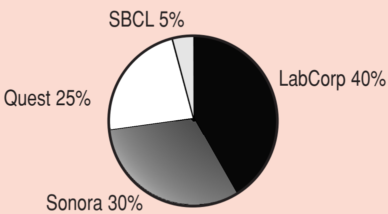
For Sonora, the consolidation with Quest will be its second major laboratory consolidation in two years. Historically, Samaritan had kept hospital in- and outpatient testing separate from Sonora's outreach activities. However, it became apparent to Samaritan's administration that the benefits from consolidating all laboratory testing within the system could no longer be ignored.

Phoenix Is Competitive Market

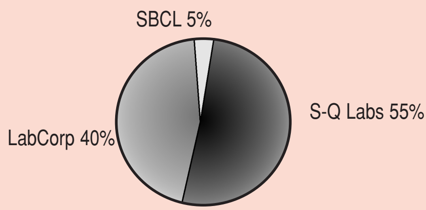
Phoenix is an extremely competitive market for clinical laboratory services. Because of the high penetration of managed care, as many as 80% of the physician offices in Phoenix use three or more laboratories. Capitated laboratory service contracts are common.

Laboratory Corporation of America formerly had the largest market share. The creation of the joint venture between Sonora and Quest will give this combined laboratory the largest market share in Phoenix.

Phoenix Market Share
*Pre-Joint Venture**



Phoenix Market Share
*Post-Joint Venture**



***Note about market share:** Estimates were developed by polling laboratory executives in Phoenix. Estimates are approximate and probably accurate within plus/minus 5%.*

Starting about two years ago, Earl Buck guided consolidation of testing between the hospitals and Sonora's off-site core lab, using an organization called Laboratory Sciences of Arizona (LSA) as the vehicle to meet operational, legal and regulatory requirements.

"Within our system, we recently brought together two distinct laboratory employee groups," said Buck. "It helped us achieve a high degree of clinical and operational integration. We want to be careful to preserve this success through the consolidation with Quest's laboratory operations. For that reason, we have a deliberate and careful consolidation plan for the two organizations within this joint venture."

Both companies are aware of the high client turnover which historically follows mergers and consolidations. It is a major goal of the joint venture to maintain seamless service to clients while integration of the two companies is under way.

To that end, the sales and field service groups at Quest and Sonora will be retained and focused on attending to existing clients. “Additionally, one sales and marketing resource we intend to add is a managed care specialist,” said Buck. “Neither Sonora nor Quest had a full-time individual in Phoenix assigned to develop and maintain relationships with the managed care plans and payers.”

High-Profile Issue

Laboratory information systems (LIS) is also a high-profile issue. “LIS is the most critical element in bringing our two companies together,” declared Buck. “At Sonora, we use **HBOC**’s ALG software. Quest is using Menlab, along with a billing program called **SYS** that we like. We recently hired a Chief Information Officer (CIO) whose role will be to work through all these issues in coming months.”

Laboratory space is another important consolidation priority. “Due to our situation at LSA, we do not have additional space to incorporate all testing at our existing laboratory,” noted Buck. “We are looking at a new site for the core laboratory. Our target is to make it operational by the second quarter, 1998.”

For managers and staff at Quest, the joint venture provides a new set of challenges. “By joining an integrated healthcare system, we now must serve a new group of clients,” stated Burgess. “These are clients normally not served by a commercial laboratory, so we have much to learn about how to best meet their needs and expectations.

“However, this is a fun challenge for us, she continued, “because we are now part of an integrated, community-based provider system. Laboratory services we provide are going into a clinically integrated environment, both inside and outside the hospital. There are new opportunities for us to add value.”

Earl Buck agreed with those insights. “Both partners appreciate the strengths which each offers to the joint venture. We have identified specific synergies which we will work to extract from this merger.”

Buck also realizes the groundbreaking nature of this joint venture. “Because there is no similar laboratory partnership like this that we know of, we have the opportunity to demonstrate the viability of this model. Clinical integration and regional laboratory services are the future of healthcare. This joint venture has the potential to marry the best of a large hospital laboratory system with the special capabilities of a national reference laboratory. We have all the resources to evolve with our marketplace.”

Joint Venture’s Progress

Progress of this joint venture between Quest Diagnostics and Sonora Laboratory Services merits close attention for two reasons. First, it represents the first working model of Quest’s emerging market strategy. Quest seeks to create similar partnerships throughout the country. Quest’s competitors also have plans to develop similar ventures, so this model could become widespread within a few years.

Second, as the first working model of an integrated system joining forces with a national laboratory in an advanced managed care market, Sonora Quest Laboratories, LLC will demonstrate whether synergies from both types of laboratory organizations can be successfully captured and applied to the benefit of clinical practice. TDR

(For further information, contact Earl Buck at 602-495-4950, Judy Burgess at 602-547-9101.)

Joint Venture In Phoenix To Be Copied Elsewhere

Reasons and motives behind this JV exist in markets throughout the United States

CEO SUMMARY: Look for the Quest-Sonora joint venture to be followed by others in coming months. Competition and marketplace realities are forcing the three national laboratories to respond with groundbreaking strategies. Hospital laboratory partners in these deals can reap significant benefits with savvy negotiations.

SHARED EQUITY VENTURES between hospitals and commercial laboratories are tough to make succeed. Only a limited number of such arrangements currently operate in the United States.

As a joint venture, **Sonora Quest Laboratories, LLC** breaks new ground for one important reason: it is an attempt to respond to the realities of Phoenix's advanced managed healthcare marketplace. Both **Quest Diagnostics Incorporated.** and **Sonora Laboratory Sciences** hope the joint venture combines the best of both laboratories to create a profitable new competitor in Phoenix.

This laboratory joint venture between Sonora and Quest also establishes a new precedent. Quest will transfer its existing operation to a new facility. The goal is to create a new core lab, under joint management, which is capable of handling the combined specimen volume from both companies participating in the joint venture.

It marks the end of an era when public laboratories dominated most regional markets, set pricing levels and were willing to increase their market share by pricing services greatly below cost.

In reality, the move by Quest to venture with Sonora is a "market partnering" strategy. Quest acknowledges that it failed to accomplish two things in Phoenix: make adequate profits and increase market share.

Sonora Quest Laboratories, LLC breaks new ground for one important reason: it is an attempt to respond to the realities of Phoenix's advanced managed healthcare marketplace.

From that perspective, Quest's partnering strategy represents good strategic thinking. As a national company, it decided to put its management time and resources into laboratory partnering models where better potential exists to increase revenue and profits.

By partnering with a strong hospital system, Quest reaps several direct benefits. First, it closes down a marginally profitable laboratory site in Phoenix and may actually gain an immediate increase in operating profit from its share of the joint venture (not counting one-time expenses of the transition).

Second, it gains a capable partner with clout in that healthcare marketplace. Over time, this aids in obtaining managed care contracts as well as improving access to physicians who are affiliated with the system.

Third, and probably the most strategic benefit, comes from the close working relationship Quest will have with the **Samaritan Health System** (owner of Sonora Laboratory Sciences). This should not be underestimated. THE DARK REPORT predicts that integrated delivery systems (IDS) will anchor healthcare services at the local level.

Invaluable Information

By becoming a partner with Samaritan, Quest accesses invaluable information, experience and insights into the needs and operational opportunities provided by integrated systems. It is a primary corporate strategy at Quest to "become a preferred partner" with integrated healthcare systems. Working with Samaritan is a way for Quest "to go to school" on the needs of integrated systems, then use this knowledge elsewhere.

Like THE DARK REPORT, Quest believes these integrated systems will be power players in every metropolitan area. Quest's future, indeed the future of every commercial laboratory, depends upon developing profitable business relationships with such systems.

This is why Quest spent two years negotiating with Samaritan to form this joint venture. On one hand, it helped resolve the marginally profitable laboratory division in Phoenix. On the other hand, it made Quest a venture partner with a recognized and respected healthcare system.

One sign of Quest's commitment to the success of the Sonora-Quest joint venture in Phoenix is their unprecedented willingness to contribute existing outreach testing volumes and revenues to the partnership. Further, Sonora was given lead in both ownership and operation of the joint venture.

Quest's Priority

Another sign of the priority Quest places on their corporate strategy of joint ventures is the fact that Quest CEO Ken Freeman will sit on the Board of Directors for Sonora Quest Laboratories. This joint venture is receiving attention from the top executives at Quest because they intend to do everything possible to insure its success.

Laboratory executives should realize that the Quest-Sonora partnership is a direct result of marketplace realities. With both reimbursement and test utilization declining, neither laboratory had the potential to expand market share and test volume in Phoenix. By joining forces, they can achieve economies of scale and provide a statewide level of service which neither laboratory could do alone.

Of equal importance, the fact that Quest is willing to consolidate its existing specimen volumes with Sonora illustrates a point THE DARK REPORT has preached for almost two years: *managed care will not subsidize excess laboratory capacity!*

Greatest Market Opportunity

The greatest market opportunity exists for those laboratory executives who recognize the truth of this economic fact and are the first in their market area to control how and when they eliminate their excess capacity.

California provides an example. **Physicians Clinical Laboratories**, **Unilab** and **Meris** continue to maintain independent lab systems which have excess capacity. They continue to operate under financial pressure. Layoffs and cutbacks take place at regular intervals.

In Phoenix, Quest and Sonora both chose to break the cycle and exercise

continued on page 9

Regionalization Strategy

Integrated Systems Recognized As Major Force In Managed Care

EMERGENCE OF integrated healthcare systems as a vehicle for clinical and operational integration has a major impact on the way laboratories organize and deliver diagnostic services.

Integrated systems bring two critical changes to the market: how laboratory services are purchased and how laboratory services are used. Instead of individual physicians choosing a laboratory, as was common under fee-for-service, now "buying consortiums" decide which laboratory will be a provider. On the user side, clinical integration requires the laboratory to interact with physicians in non-traditional ways.

Quest Diagnostics Incorporated recognizes the strategic changes now transforming the laboratory marketplace. This led Quest to seek out partnerships with integrated systems in various cities.

"This transaction at Quest builds upon the experience that Ken Freeman had at **Corning Incorporated,**" stated James Chambers, Vice President, Administration. "Joint ventures were a successful business vehicle for that company. It is reasonable to expect that similar joint ventures can succeed in healthcare.

"We believe that joint ventures are an effective way to build value," he continued. "However, it is essential that the participants have shared values. When you snuggle up to a partner for the long term, shared values play a major role in the success or failure of the venture. During the two years of negotiations with Samaritan, both organizations came to realize how much was shared in common by both groups."

Chambers acknowledges that Quest has laboratories which have not performed well. This influences the joint venture strategy. "Of course we have a number of laboratories in our national system which are marked by low profit margins or low market share. As reimbursement decreases and utilization declines, those laboratories become increasingly difficult to sustain over time.

"This made us appreciate the mutual benefits which would follow from aligning with a significant player in these cities," observed Chambers. "You can expect to see Quest explore similar arrangements throughout the country. We believe there is synergy in combining the things we do well with the individual strengths of locally based integrated healthcare system."

Don't expect a cookie-cutter approach with Quest. They appreciate regional differences. "We absolutely see different healthcare structures in different cities," explained Chambers. "We tailor solutions on a region-by-region basis. Further, we know that rapid evolution in the marketplace requires each unique joint venture to evolve and adapt over time."

Because of Freeman's background with quality management principles, one value Quest Diagnostics Incorporated seeks in a potential partner is a focus on process. "This is an important shared value for both of us," noted another executive with the joint venture. "If a partner understands the importance of process as a way to evolve with changes to technology and the marketplace, it permits the resulting joint venture to successfully adapt as healthcare is transformed from fee-for-service to managed care."

market leadership. In theory, they should now prosper relative to their competitors in Phoenix. There is always risk to being a market leader. However, rewards are commensurate with risk and both laboratory organizations are now positioned to earn such rewards.

Another Motive

It is also important to understand another motive behind Quest's willingness to dismantle the Phoenix laboratory and pool their specimens and revenues with Sonora. Quest understands that "value-added" in the future does not lie in performing diagnostic tests. Rather, it derives from information, knowledge and management contribution.

Why are computers and Nike athletic shoes designed in the United States and manufactured overseas? The added value is in design and information, not in assembly of the final product.

This is why Quest is beginning to strip out the "manufacturing" component of diagnostic testing. It is beginning its evolution into an information-based diagnostic provider. There will be a transition period in the clinical marketplace before this becomes a widespread phenomenon. But Quest is positioning itself early on this curve.

Further Speculation

THE DARK REPORT can speculate further. With Quest's experience in total laboratory automation at major laboratories in St. Louis and Denver, it may be that Quest also recognizes how rapidly point-of-care and near-patient testing technology could render the centralized laboratory obsolete.

Again, this would be one more strategic reason for Quest to begin evolving from a "laboratory test result manufacturer" toward a "clinical information provider."

It is precisely this strategy which drives **UroCor, Inc.** of Oklahoma City. Guided by this vision, UroCor's revenue and profit growth during the past four years is exceptional, a track record not shared by any public commercial laboratory during the same period. Urocor's success demonstrates the importance of diagnostic information in a value-added context. *(See TDR, June 23, 1997.)*

As THE DARK REPORT's analysis of the Sonora-Quest joint venture indicates, there are several sophisticated management strategies at play. Financial motives may have impelled Quest to solve its Phoenix problems, but the solution is actually a futurist strategy. TDR

(For further information, contact James Chambers at 201-393-6189.)

Obvious Cost Gains For Sonora & Quest

In combining the two laboratories, these elements represent the immediate financial benefits to both laboratories:

Lower Average Cost Per Test: By combining specimen volumes, a lower average cost-per-test results.

Consolidation of Laboratories: Eliminates duplicate instruments, couriers, excess capacity and redundant staffing.

Managed Care Contracts: Both laboratories have different contracts, so the combined laboratory can serve more physicians.

Service Infrastructure: Combining both labs improves courier route structure and offers improved access throughout the entire state at draw sites and stat labs.

Mass Purchasing: Because of Quest's buying power, it brings significantly lower prices for instruments, reagents and supplies to the partnership.

Reference Testing: Were the joint venture given Quest's preferred internal pricing for reference testing, valuable savings could result.

Market Trend Update

Big Hospital-PPM Alliance Announced For New York

CEO SUMMARY: This alliance involves PhyCor and the New York and Presbyterian Hospitals Care Network. Like the MedPartners/Tenet deal in California reported in our last issue, this joint venture will have far-reaching impact upon the local healthcare marketplace it serves.

HOSPITALS ARE LEARNING that physician practice management companies (PPM) might be an effective way to organize physician practices within their healthcare system.

Should this prove true, then consortiums of hospital systems and PPMs could rapidly develop as buyers of laboratory and other clinical services in cities throughout the United States.

Just two weeks ago, **PhyCor** signed a letter of intent with the **New York and Presbyterian Hospitals Care Network**. PhyCor will organize several thousand physicians participating in the network. These physicians practice in 19 counties in Connecticut, New Jersey and New York.

It is expected that PhyCor's exclusive deal with hospitals in the network will encourage physicians to merge their practices and create equity-sharing arrangements with PhyCor.

The direct consequence of the network agreement is that PhyCor and the network are forming a joint venture management company. PhyCor's **North American Medical Management** subsidiary is to develop 21 new independent practice associations (IPA). North American will offer capital, medical management services and administration to both existing and proposed IPAs.

With all these IPAs under common management, it should be expected that a master contract for laboratory services would result at some point in the future. Covering thousands of doctors in 19 counties, it would represent a sizeable chunk of laboratory testing.

Joseph Hutt, PhyCor's President and CEO, pointed out that the hospital network needed to quickly develop a response to managed care. The network realized that rapid organization of physicians was essential for contracting and service reasons.

"I think you're going to see more of those around the country," noted Hutt. "Hospitals are beginning to realize that the physician company is not a competitor, but that the hospital can work effectively with them."

This is the third similar joint venture for PhyCor. Taken in context with the **MedPartner/Tenet** deal in Southern California, involving 33 Tenet hospitals and 4,000 MedPartner doctors, it illustrates how swiftly individual PPMs can become major players in regional markets. *(See TDR, July 14, 1997.)*

Laboratory executives should be alert to similar arrangements in their own cities. Timely marketing to such ventures could generate worthwhile revenues. TDR

Probe of Columbia/HCA Generates Indictments

Look for laboratory billing practices to play significant role as the investigation expands

CEO SUMMARY: Hospital laboratory executives should pay close attention to how federal prosecutors develop their case against Columbia/HCA. Earlier "Labscam" settlements with commercial laboratories and hospital laboratory billing practices centered around restitution and fines for improper billing. In the case of Columbia, criminal charges against key executives will be an overarching part of this investigation.

NASHVILLE-BASED hospital giant **Columbia/HCA Healthcare Corp.** now dominates national headlines. FBI raids and recent indictments point to serious problems with how Columbia billed Medicare and Medicaid programs.

Of equal concern to federal investigators are referral and compensation arrangements between Columbia hospitals and physicians. Apparently any type of violation will be considered in this far-ranging investigation, as the first indictments against Columbia officials deal with how a Florida hospital owned by Columbia "submitted fraudulent reports to three fiscal intermediaries."

Billing for CBC testing (complete blood count) is a part of the investigation. Several physicians employed by Columbia were interviewed by FBI agents prior to the July raids. These physicians told the media that FBI agents worked from prepared scripts of questions four or five pages long. Questions dealt with how blood tests were ordered by emergency room doctors. From statements by these physicians, it appears FBI agents were seeking information about whether more laboratory tests were performed than those ordered by the doctor, as well as whether those same tests were medically necessary.

> ***"With the indictment of three executives of Columbia/HCA Healthcare Corporation, law enforcement officials are sending a powerful message to administrators and financial executives in the healthcare industry: Be very afraid."***
>
> **-Kurt Eichenwald**
> *New York Times*

During the raids, at least one hospital was specifically probed about laboratory billing practices. **Columbia Tulsa Medical Regional Medical Center** was asked to provide data on outpatient laboratory tests going back to 1991. This was four years before Columbia/HCA acquired the hospital.

Laboratory executives in both commercial and hospital labs should carefully follow this investigation of Columbia/HCA. Healthcare fraud has become a major priority of the

Details About The Earliest Indictments Involving Columbia/HCA Executives

GOVERNMENT PROSECUTORS UNSEALED indictments last Wednesday against three Columbia executives. The indictments accuse the three of engaging in a conspiracy to defraud the government going as far back as ten years.

The charges revolve around government claims that the three executives inflated the amount of money Columbia was to be reimbursed by the federal government. Specifically, the three executives are accused of illegally manipulating cost-accounting processes to allow 100% of certain types of debt to qualify as reimbursable by federal programs such as Medicare and CHAMPUS.

Named in the indictment were Jay A. Jarrell, Michael T. Neeb and Robert W. Whiteside. All three served in Columbia's Florida region and face prison terms of as much as 25 years and up to $1 million in fines.

This is the first round of indictments. Prosecutors' strategy will be to get cooperation from these individuals in order to implicate higher ranking officials within Columbia/HCA. During the next six months, further indictments of Columbia/HCA executives should be forthcoming.

Department of Justice (DOJ). Future investigations and settlements will be unlike the earlier Labscam settlements with the major commercial laboratories. In the Columbia case, federal prosecutors are coming after the alleged violator with fangs bared and claws unsheathed.

This raises the stakes for lab executives in both commercial and hospital laboratories. Earlier Labscam settlements tended to result in the laboratory agreeing to repay the amount improperly billed, plus some penalty. In only two cases were criminal charges a part of the federal settlement with the offending laboratory.

The Columbia/HCA case represents a watershed change in how federal prosecutors use criminal indictments against healthcare executives. First, there has been high visibility by the FBI in the Columbia case. Raids to seize company records in El Paso in March and 35 Columbia hospitals in seven states in July were well-publicized by the national media.

This high-profile involvement by the FBI raises the ante for government prosecutors. If they cannot make a case against Columbia, there will be criticism by both Congress and the public about undue harassment of a wrongfully accused private company.

Evidence Gathered Early

Remember Richard Jewell in the Atlanta Olympic bombing last summer? The FBI wants no repeat of that episode, so it can be assumed that evidence gathered early in this investigation gave government prosecutors a high degree of confidence that they will extract a major settlement from Columbia. Confidence in prosecutors' belief they have a strong case is further indicated by the fact that 700 federal agents are involved in the Columbia investigation.

Second is the use of criminal indictments early in the development of this case. The three indictments unsealed in Florida last week provide graphic proof that criminal charges against individual executives at Columbia will be a major part of this investigation.

That is why laboratory executives should pay attention to the details of this case. It will provide them with knowledge about the new legal approaches used by government prosecutors to investigate and punish alleged cases of Medicare fraud and abuse. In particular, the increased attention to criminal indictments of individual managers is a key difference from earlier settlements.

Another interesting twist to the Columbia story is also a warning to laboratory executives. Private insurers are investigating as to whether Columbia overbilled them. In particular, they want to know if reimbursement claims were inflated or they were charged for unnecessary services.

Lab Practices Scrutinized

Evidently an attorney representing several major insurance companies is traveling throughout the country. This attorney is interviewing ex-Columbia employees specifically to investigate possible claims in Columbia's billing of home-health services and clinical laboratory work. However, other general billing practices are of interest.

During Labscam, the private insurance industry did not pursue possible claims against commercial laboratories. This was probably for three reasons. First, there was no precedent for considering issues of test unbundling and medical necessity as fraudulent, particularly in the private sector.

Second, the statute of limitations for civil action probably influenced decisions as to whether and how to proceed with civil recovery suits against the large laboratories.

Third, the cost of pursuing such lawsuits versus the potential recovery probably dissuaded private insurers from filing civil suits against the major commercial laboratories.

Finally, even as managed care was transforming the laboratory industry and healthcare in general, so also were private insurance companies undergoing a similar upheaval. It was not an executive priority to attempt the recovery of money from commercial laboratories for billing practices which were not considered inappropriate at the time.

Private Insurers Investigate

So why would private insurers now choose to investigate and pursue claims against Columbia? Knowledgeable observers tell THE DARK REPORT that the potential amount of money to be recovered from Columbia is immense if it can be proved that the company billed for services not performed, unbundled or upcoded without justification.

In addition, these same individuals speculate that, as private insurance plans acquire knowledge and expertise in how to investigate such abuses, there is an equally lucrative opportunity to pursue claims against other

New CEO At Columbia Has Ethical Concerns

BY LAST WEEKEND, Columbia's high-profile President and CEO, Rick Scott was out. In his place, the Board of Directors appointed Thomas Frist, Jr., M.D. as CEO.

*Frist and his father founded **Hospital Corporation of America**, which was acquired by Columbia in 1994. Frist is already pulling Columbia out of negotiations for a variety of business enterprises. It is known that both he and his father were concerned about the direction Columbia was taking and its emphasis on financial performance rather than the quality of the heathcare.*

*Waiting in the wings is another potential double play. A merger of Columbia with **Tenet Healthcare** has been discussed. Also, Tenet's CEO, Jeffery Barbakow has been mentioned as a possible CEO for Columbia. Barbakow was originally hired by Tenet to resolve federal charges of Medicare fraud at Tenet's predecessor company, **National Medical Enterprises**.*

healthcare providers. This could include clinical laboratories.

To understand why government prosecutors have become so aggressive in prosecuting healthcare fraud, it is important to look at how government enforcement works.

Problem Becomes Obvious

First, government enforcers generally do not act until a problem is so obvious that it cannot be ignored. Alternatively, publicity about a problem can create enough embarrassment over their lack of response to spur them to action.

C. Jack Dowden, the original whistleblower in the **National Health Laboratories** case, has told THE DARK REPORT that government regulators not only ignored his formal approaches to notify them of the abusive practices in laboratory billing of Medicare, but they even argued among themselves as to whether they should proceed after they joined Dowden's *qui tam* (whistleblower) lawsuit against NHL.

According to Dowden, these spirited internal disagreements continued even up to the night before NHL signed the $110 million settlement in 1992. Dowden believes that government enforcement generally is too little, too late. When the crackdown finally comes, offenders often feel like their prosecution is unwarranted, excessive or unreasonable.

Defending "Righteousness"

The second factor which motivates government enforcers is their feeling that they are defending "righteousness." If an offender has knowingly violated the law, then punishment should be swift and powerful. Let the offender's sentence send a message to the public.

It was precisely this motivation to "send a message" which increased the penalties Ohio hospitals were required to pay in the investigation reported by THE DARK REPORT in July, 1996.

In that interview, Assistant U.S. Attorney James L. Bickett explained why prosecutors were seeking large penalties on top of the repayments of improperly billed amounts. "We have told hospitals that it is no longer the old ball game. Under those rules, if we catch you, you pay without interest. That is why each of these settlements contain compliance provisions. On a go-forward basis, we want to see more effective management involvement in compliance and oversight functions within the hospital. Also, the settlement amounts reflect a penalty amount and costs of the investigation are being recovered through the settlements."

Prosecutors' Attitude

Bickett's comments reveal that the attitude of prosecutors becomes increasingly unsympathetic as they come to believe that healthcare executives are "gaming the reimbursement system" illegally, without fear of punishment.

For this reason, the investigation into Columbia/HCA may develop into a major case, with record fines. It is no secret that Columbia is viewed as more than the 800-pound gorilla in the hospital industry. It had become the Godzilla monster which was wreaking havoc on competing hospitals in markets where it was most aggressive. This lack of popularity and respect will not serve Columbia well during the course of this investigation.

THE DARK REPORT predicts that the hospital laboratory segment of the industry has not seen the last of federal investigators. As prosecutors continue to successfully settle additional cases of healthcare fraud and abuse, laboratory billing practices will remain in the gunsights. TDR

(For further information, contact THE DARK REPORT at 503-699-0616.)

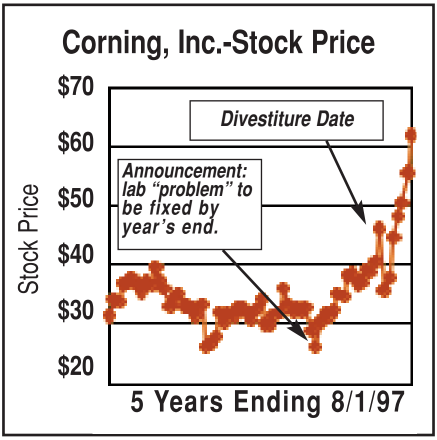
The Dark Index

Corning Stock Price Skyrockets Since Spin-Off Of Corning Labs

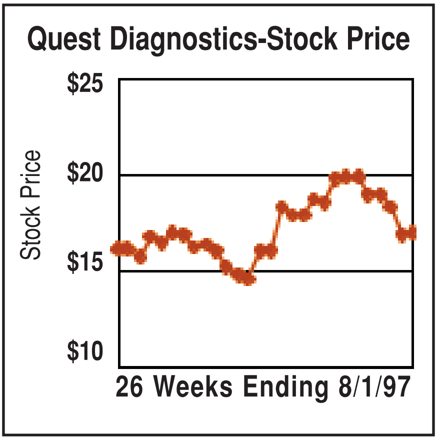
STOCK PRICES of **Corning Incorporated** have climbed since the divestiture on January 1, 1997 of **Corning Clinical Laboratories** and **Corning Life Sciences** into **Quest Diagnostics Incorporated** and **Covance, Inc.**, respectively.

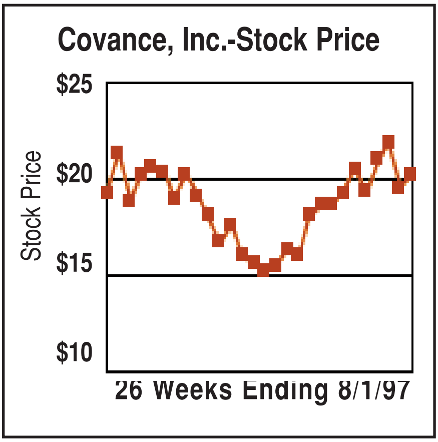
During 1995 and 1996, few laboratory executives knew how much of a financial drag Corning Labs was to its parent company. This financial pressure led directly to the spin-off of MetPath/Corning Labs into Quest Diagnostics Incorporated.

During the four-year period 1992-1996, Corning share values declined to as low as $24. It was not until Corning announced plans to rid itself of the laboratory division that the share price began to climb. At divestiture date, December 31, 1996, Corning shares closed at $46 1/4. As of August 1, 1997, shares had climbed to $61.



As the charts on this page indicate, since their formation as independent corporations, neither Quest nor Covance has yet impressed investors with either earnings or near-term potential. Quest's ability to raise capital is directly dependent on its financial performance and share price, so this is an important indicator to watch. **TDR**





Dynacare Inks New Pact With Milwaukee Hospital

Canadian laboratory continues U.S. invasion, other partnerships may soon be announced

CEO SUMMARY: Dynacare is on the move again. Its latest partnership is with a leading Milwaukee hospital. Dynacare's aggressive marketing effort to develop joint ventures with hospital laboratories will continue. It may announce more new contracts by year's end.

DEALMAKERS FROM **Dynacare's** U.S. operations continue to press hospitals from coast to coast. Last Wednesday **Froedtert Memorial Lutheran Hospital** in Milwaukee confirmed a partnership agreement with the Canadian-based laboratory.

Froedtert had earlier formed **United Regional Medical Services** (URMS) to develop a regional laboratory outreach program in the greater Milwaukee area. Dynacare will partner with Froedtert's URMS division in the joint effort to capture outreach testing.

Tom Mattison, President of URMS, stated that the partnership seeks to double its business during the next three years. Dynacare and URMS will each contribute $1 million to capitalize the partnership. The partnership agreement becomes effective on August 1, 1997.

Another Opportunity

For Dynacare, it is another opportunity to repeat the same strategic plan it followed with partnerships in Houston and Schenectady. Dynacare wants to find a hospital partner with significant volumes of in- and out-patient testing, but little outreach business. Dynacare contributes capital, management expertise and professional sales/marketing skills to the partnership. The hospital provides existing laboratory resources plus access to physicians in the neighboring medical office buildings.

Partnership's Potential

The potential of the partnership to capture significant business makes Tom Mattison excited about the new venture. "We feel there is an opportunity to compete with national commercial laboratories doing work in Milwaukee and southeastern Wisconsin," he said. "This is a real growth story. We feel we can become very competitive."

Mattison's laboratory operation currently employs 228 people. It provides testing to **Wauwatosa Hospital** and the related **Medical College of Wisconsin Clinics**.

"From Dynacare's perspective, Froedtert provides ideal resources from which to develop a healthy outreach business," stated Miles Standish, Dynacare's Marketing Specialist. "Froedtert is the only class-one trauma center in Wisconsin. It operates a sizeable heart institute and an organ trans-

Overview Of Dynacare's U.S. Operations

Dynacare's presence in the United States has grown steadily since it first acquired laboratories in the United States in 1994.

Based in Toronto, Canada, Dynacare is one of Canada's largest laboratory companies. It was publicly traded until earlier this year. With the help of a Chicago investment banker, Dynacare repurchased its shares and went private.

Dynacare Cheyenne Laboratories; Cheyenne, WY: Acquired in 1994. Owned and operated by Dynacare.

Dynacare Skagit Valley Laboratories; Mt. Vernon, WA: Acquired in 1994. Owned and operated by Dynacare.

Dynacare Laboratories; Seattle, WA: Acquired in 1995. Owned and operated by Dynacare. Serves Swedish Hospital under a long-term contract.

Dynacare Hermann Laboratory Services; Houston, TX: Partnership with Hermann Hospital. Launched in September 1995.

Dynacare Ellis Laboratory Services; Schenectady, NY: Partnership with Ellis Hospital. Launched in June 1996.

United/Dynacare; Milwaukee, WI: Partnership with Froedtert Memorial Lutheran Hospital's United Regional Medical Services Division. Agreement effective August 1, 1997.

plant center. To support these services, the laboratory provides an expanded range of testing."

Dynacare executives hint that other partnership announcements may be forthcoming. One confirmation of this possibility is the reshuffling and expansion of Dynacare's executive team in the United States.

New Executive

The new executive is Bert Koch, who will be Vice President of U.S. Operations for Dynacare. Koch comes to Dynacare from **Laboratory Corporation of America**, where he was Vice President, Alliances and Acquisitions. Prior to LabCorp, Koch served with **National Health Laboratories**. Longtime industry observers were surprised at Koch's departure from LabCorp to Dynacare.

Osama Sherif, Executive Vice President of Dynacare U.S., has moved from Seattle back to Toronto headquarters. He will continue to oversee new business development in the United States, including partnerships and acquisitions.

Dynacare brings a unique partnership model to the laboratory marketplace. Although its first joint venture, with **Cedars Sinai** in Los Angeles, is winding down after three years, the **Dynacare Hermann Hospital** partnership in Houston has performed well during its second year of operation.

The Dynacare partnership model incorporates three themes which **THE DARK REPORT** consistently finds in successful hospital laboratory outreach programs. One, a professional sales program is launched and maintained. Two, laboratory services are delivered which equal or exceed those of competing commercial laboratories. Three, the parent hospital has given the laboratory independent resources in executive leadership, billing, human resources and accounting.

As with the Sonora-Quest joint venture profiled on pages 2-9, the United/Dynacare partnership is another example of how hospital laboratories are seeking to expand outreach testing. **TDR**

(For further information, contact Miles Standish at 800-458-6836.)

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Impressions from the AACC's annual convention in Atlanta in July: With more than 16,000 attendees, it is much larger than CLMA. International attendees comprised at least 25% of that number. The exhibit hall is heavy on technical products and instruments. Conspic-uously absent as exhibitors were the major LIS vendors and reference laboratories. The AACC's traditional emphasis on technical and scientific presentations meant that workshops on different aspects of laboratory management were not as comprehensive as what is typically found at CLMA.

"Plug and Play" for HL7 standard software is the goal of **Hewlitt Packard**'s Andover Working Group (AWG). Ten companies, including **HBO & Company** and **Sunquest Information Systems**, recently became "core members" of AWG. This requires each company to dedicate a full-time programmer to the effort. Launched in 1996, AWG has 24 core members and 200 supporting members.

PPM-HOSPITAL DEAL

In New York City, **Beth Israel Medical Center's U.S. Management Systems** was acquired by **PhyMatrix**, a physician practice management firm. *(See page 10 for a similar transaction.)* In a fifty-fifty partnership, PhyMatrix and Beth Israel will form a management services organization to manage the 2,000+ independent practice association physicians affiliated with Beth Israel's parent organization, **Greater Metropolitan Health Systems**.

More news on the Atlanta reference laboratory joint venture between **MDS/Autolab** of Canada and **Columbia/HCA**. Test instruments and Autolab's automated laboratory equipment are arriving daily at the facility. Columbia is telling hospital laboratory administrators in their 20 Georgia hospitals that the reference laboratory will become operational on October 1, 1997. Apparently reference work from the hospitals will flow in stages to the Atlanta lab, as different lines of testing are activated sequentially over time.

A new development in the managed care wars: **Highmark Blue Cross Blue Shield** of Pittsburgh announced that it would only enter contracts with individual hospitals, not systems. Highmark, formed from the merger of **Blue Cross of Western Pennsylvania** and **Pennsylvania Blue Shield**, has 2.5 million enrollees including 60% of Pittsburgh residents. "I view this as a pre-emptive strike to blunt the growth of the tertiary care networks," observed William Hannah, a Pittsburgh-based healthcare consultant. "Highmark is not going to be put in a position of being leveraged by these networks."

ADD TO:... PITTSBURGH

Highmark's attempt to outflank the power of emerging hospital systems indicates that insurance companies understand the threat represented by such systems. Pittsburgh demonstrates that the eventual winners and losers in advanced managed care markets have yet to be determined.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, August 25, 1997

THE DARK REPORT

UPCOMING...

- New Players Join Competition To Build Pathology Practice Management Companies.
- Careful Strategic Planning Prepares A Regional Laboratory Network For Success.
- Techniques To Purchase Laboratory Instruments At Surprising Savings.
- Regional Laboratory Consolidation Takes Interesting Directions North Of The Border.