Volume IX, Number 13 Monday, September 16, 2002

From the Desk of R. Lewis Dark...

THE DARK REPORT

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

Restricted information, see page 2

Commentary & Opinion by...

R. Lewis Dark

Founder & Publisher

Removing Lab Players From the Chessboard

IN 1997-98, CEO Ken Freeman of **Quest Diagnostics Incorporated** made a keen insight about the commercial lab marketplace. At that time the three blood brothers—**Laboratory Corporation of America**, Quest Diagnostics, and **SmithKline Beecham Clinical Laboratories** (SBCL)—dominated the national market for physicians' office testing. Freeman's observation would be prophetic. He noted that, in any industry dominated by three large companies, market forces would soon reduce that group to just two.

Because each of the three blood brothers was laboring to restore financial stability in 1997-98, each was potentially vulnerable to consolidation. On May 13, 2002, I wrote a piece called *Survivor: Story of the Nation's Largest Lab Firm*. It described how, since 1997-98, Freeman successfully guided Quest through the ensuing market shake-out to emerge as the nation's largest lab firm.

This fine management achievement seems to have another dimension, however. Beginning this January, acquisitions removed **American Medical Laboratories** and **Dynacare** from the market. Unilab is under merger agreement and may also disappear as an independent lab company. As THE DARK REPORT did research to understand the significance of these acquisitions and their impact on the lab industry, it uncovered an interesting pattern involving the three biggest lab acquisitions done by Quest Diagnostics in recent years.

In the late 1990s, SBCL aggressively used low prices to protect and expand its share of physicians' office testing. In 1999, Quest bought SBCL. During the past few years, AML emerged as an aggressive price discounter in the market for hospital send-out testing. This January, Quest bought AML, announcing the deal just days before AML was to sign a national reference testing contract with Premier at some eye-popping low prices and terms. *(See pages 9-13.)* In California, Unilab has used its willingness to do capitated, full-risk contracts with IPAs to keep lab prices in that state at uncomfortably low levels. This April, Quest Diagnostics announced an agreement to buy Unilab.

Is it coincidence that, three times in the last three years, Quest Diagnostics acquired a sizable lab competitor which was the aggressive price discounter in one segment of the lab testing market? Or is this an intentional strategy to remove key competitors from the market, exactly the type of antitrust behavior characteristic of a classic corporate oligopolist? Certainly Quest's actions in the coming years will reveal the true motives behind its apparent drive to remove low-pricing lab competitors off the chessboard. TDR

Esoterix Ready to Launch National Marketing Blitz

Company says it's ready to compete vigorously across the United States

CEO SUMMARY: It was 1995 when several specialty testing lab companies were acquired by a new company called Esoterix. Immediately the lab industry viewed Esoterix as a "put-together" lab company. However, since 2000, executives at Esoterix have invested $50 million to integrate operations, create a new informatics platform, and position the company to compete for reference and esoteric testing.

FOLLOWING ALMOST THREE YEARS of preparation, **Esoterix, Inc.** is ready to stake its claim as a major player in the nation's market for reference and esoteric testing.

"Esoterix is going to surprise a lot of people in the laboratory business," declared James A. McClintic, President and CEO of Austin, Texas-based Esoterix. "Today's Esoterix is not a chain of specialty labs located in different cities around the country. In recent years Esoterix has developed an integrated operational structure supported by what we believe is a 'best of class' informatics capability.

"Timing couldn't be better for us," added McClintic. "Lots of relationships are changing in the hospital send-out market this year as a result of new owners at **American Medical Laboratories** (AML), regulatory problems with **Specialty Laboratories**, and other marketplace events. These developments occurred just as we implemented our new informatics system and added to our sales team."

Strategic business planning for the "new" Esoterix took place in early 2000. Since that date, Esoterix spent almost $50 million to reshape itself. "It's unheard of for a $68 million laboratory to spend that kind of money in just three years," explained McClintic. "It demonstrates the level of support we have from our owners.

"It's our view that information technology is critical to the success of an esoteric testing laboratory," he said. "That's why we spent $30 million of

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THE DARK REPORT Intelligence Briefings for Laboratory CEOs, COOs, CFOs, and Pathologists are sent 17 times per year by The Dark Group, Inc., 1731 Woodland Terrace Center, Lake Oswego, Oregon 97034, Voice 1.800.560.6363, Fax 503.699.0969. **(ISSN 1097-2919.)**

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SUBSCRIPTION TO THE DARK REPORT INTELLIGENCE SERVICE, which includes THE DARK REPORT plus timely briefings and private teleconferences, is $11.90 per week in the US, $12.50 per week in Canada, $13.55 per week elsewhere (billed semi-annually).

the $50 million on creating an entirely new informatics system. It uses the latest software technology and allows us to do things that competing labs cannot match."

New Business Strategy

In early 2000, as part of its strategic planning process, Esoterix decided to organize itself around three core businesses: clinical trials, oncology, and laboratory services. "Our core business was sound," recalled McClintic, "but we weren't getting synergy from our several specialty testing labs. We decided that it was time to centralize the operational functions of the corporation and evolve toward a different business model.

"As this occurred, it allowed our scientists to concentrate exclusively on laboratory testing. Among other things, during the past three years our test menu expanded from about 1,000 tests to over 1,600 tests. This closed gaps in our test menu and positioned us to be a full-service reference and esoteric testing resource for hospital labs and other clients," noted McClintic.

"Because of the tremendous opportunities in clinical trials, one of the first things we did back in 2000 was create the Esoterix Center for Clinical Trials," he continued. "We hired a sales team to market our clinical trials services and this line of business has grown rapidly. In the past 30 months, revenues from clinical trials have tripled."

Information Technology

McClintic believes that information technology will be a key asset in competing for reference and esoteric testing business. "Esoterix now possesses one of the most modern and capable IT systems in the lab industry—bar none!" he declared.

"When Esoterix was first formed, it found itself with seven legacy IT systems," noted McClintic. "Each was a custom system and none could talk to each other. That proved to be a blessing. None of our legacy systems could support our new business plan. That is why we created, from scratch, an entirely new informatics system.

"As a multi-site laboratory doing reference testing we have unique operational needs," he added. "We are a 'send-out lab's' send-out lab. Much of our testing is done in support of very sick patients.

"One big issue in our business is logistics. How do we pick up specimens in a way that meets the needs of our client hospitals and physicians?" McClintic asked. "For example, we don't pick up routine chemistry and hematology specimens and feed them into a high volume lab. A single pickup can involve specimens for testosterone, allergy, and bone marrow testing. We wanted our IT solution to support this type of specimen mix.

Building IT From Scratch

"Not surprisingly, we quickly recognized that a comprehensive information system was needed before we could apply work flow and process redesign techniques to all aspects of our operations. For example, logistics benefits from bar code capability. Because we had no legacy IT platforms that could be scaled up, we built one from scratch," McClintic said.

"We've developed our IT system through eight different projects. One early project was the implementation, in January 2001, of a single report, regardless of how many Esoterix lab sites performed tests for a specific patient. Our IT system offers this same uniformity for most other lab functions," observed McClintic.

"Our IT system was also developed to support another corporate goal," he continued. "Our promise to clients is 'make one phone call and you'll have

Esoterix Organizes to Attack Three Lab Testing Segments

Beginning in early 2000, Esoterix launched its new business strategy: a unified national laboratory services company focused on three divisions: clinical trials, oncology, and laboratory services. The glue that binds it together is a brand-new informatics system, developed within Esoterix.

ESOTERIX CORPORATE
James A. McClintic–President/CEO
In Austin, Texas: centralized finance, IT, customer service, reporting, billing, marketing

CLINICAL TRIALS
Anthony Busa–President
Bill Biggs–VP Sales

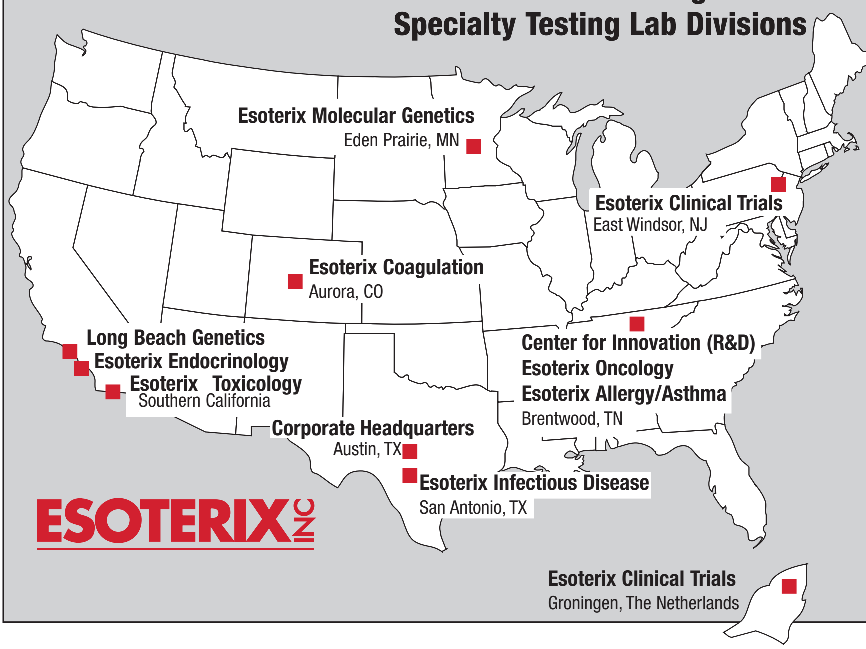
ONCOLOGY
Robert A. Mignatti–President
Robert P. Walker–VP Sales

LABORATORY SERVICES
Darryl Goss–President
William H. Crawford–VP Sales

Esoterix, Inc.
At-A-Glance

Founded:	1995
Headquarters:	Austin, Texas
Revenues:	$68.7 million in 2001
Specimens:	80,000 per month
FTEs:	600
Sales Reps:	54 total
Lab sites:	11 in the U.S.A., 1 in The Netherlands

Esoterix Has A Growing of Network Specialty Testing Lab Divisions



ESOTERIX INC

your answer about specimens, billing, results, and access to scientific expertise.' We've just invested in a state-of-the art digital phone product that creates a single phone network serving all our labs and facilities nationwide.

"By March 31, 2003, this phone system and our IT software will insure that any caller can connect, without delay, to a lab scientist and that the scientist can swiftly access pertinent information from the computer," said McClintic.

> ***Even as Esoterix underwent its operational and strategic transformation during the past three years, few in the lab industry took notice.***

Esoterix is also taking inspiration from two masterful laboratory pioneers who shaped the esoteric testing industry that exists today. "We've studied the success Dr. Al Nichols had in using academic associates to push **Nichols Institute** into the forefront of advanced diagnostic technology," noted McClintic. "In a complementary way, Dr. James Peter demonstrated that branding of esoteric testing was a powerful method to establish a competitive market presence.

Science Is Trump Card

"Because we believe strong science trumps all when meeting the reference testing needs of hospitals and physicians, Esoterix is building close relationships with academic experts," he explained. "These are marketed in a way that builds brand identity and loyalty to Esoterix. In fact, in the last 12 months, we've launched 12 new brands. Eight are molecular genetics assays because we recognize the growing role of molecular diagnostics."

As Esoterix implemented its corporate reorganization and made sizeable investments in new information technology solutions, it continued to post strong gains in revenue. "We are on track to increase revenue by 25% during 2002, following two years of 17% per year of growth," McClintic said. "We also have a goal of increasing EBIDTA (Earnings Before Interest, Depreciation, Taxes, and Amortization) to 15% per year and we are right on top of that. We believe we are the fastest-growing lab in the United States, when measured on same-store growth from year-to-year."

Changes Went Unnoticed

Even as Esoterix underwent its operational and strategic transformation during the past three years, few in the lab industry took notice. That may soon change. With most of its new IT capabilities in place and many operational reforms completed, Esoterix is beefing up its three sales forces (clinical trials, oncology, and laboratory services). It aims to develop a higher profile in the reference and esoteric testing market.

The most unusual part of the Esoterix story is the willingness of its owners to invest almost $50 million over three years in a company generating annual revenues of $68 million. If informatics is a key to success in the coming age of genomic and proteomic testing, then Esoterix's new $30 million IT platform should help it become a tougher competitor.

Armed with its $50 million "better mousetrap," Esoterix is ready to test the market. However, as the acquisitions and regulatory actions of 2002 demonstrate, the marketplace for reference and esoteric testing continues to upset the business plans of even the most well-established reference lab competitors. **TDR**

Contact James A. McClintic at 512-225-1100.

Non-Pathologists Altering U.S. Laboratory Industry

Lack of entrepreneurial pathologists holds back the entire profession

CEO SUMMARY: It's an interesting contradiction. On one hand, most pathologists enthusiastically recognize the value that diagnostic testing services provide to the healthcare community. On the other hand, too often it is non-laboratorians who provide the investment capital and entrepreneurial effort required to build the laboratory organization capable of delivering these diagnostic services.

IS THE APPARENT PAUCITY of pathologist-entrepreneurs causing the pathology profession to lose control over its destiny?

This is an important question for the pathology profession. During the 1980s, virtually all laboratory companies had been founded by pathologists, and pathologists held major leadership and management roles. Pathologist-domination of the lab testing industry gave them control over their destiny and significant influence in legislative and regulatory activities that affected their profession.

Dwindling Path Influence

That situation changed during the 1990s. The number of influential laboratory companies owned and controlled by pathologists dwindled. Not surprisingly, as this trend played out, it diminished the pathology profession's collective clout and influence with legislators, regulators, and the investment banking community.

During this fresh decade of the 2000s, the diminished role of pathologists in the laboratory testing marketplace is apparent. A handful of public laboratory and anatomic pathology companies dominate the headlines.

Public Labs Set Agenda

It is their agenda which too often frames the debate about legislation affecting diagnostic technology and reimbursement. It is their missteps and inappropriate actions which often subject the entire lab industry to greater scrutiny and criticism.

The counterweight to this cluster of public lab and anatomic pathology companies continues to be the 3,500 or so local pathology group practices. However, the small size and parochial interests of these private pathology groups means that they have relatively little influence in some of the most important debates that affect the pathology profession.

In the 1980s, there was a sizeable middle-market between the big public lab companies and the private pathology groups. That's because larger numbers of pathologists were then willing to assume entrepreneurial risk to expand their business. As their labs grew and became strong regional competitors, so also did their influence and leadership in legislative and regulatory matters affecting the pathology profession.

Entrepreneurial Vacuum

The story of **Esoterix, Inc.** illustrates how non-pathologists have filled the entrepreneurial vacuum. As explained in the sidebar at right, it was two professional investors, doing their homework, who recognized the value of esoteric testing as a profitable business opportunity. Starting in 1995, they began acquiring specialty testing labs and have continued to provide working capital to boost the growth of their acquired labs.

At **Quest Diagnostics Incorporated** and **Laboratory Corporation of America**, pathologist-founders Paul Brown, M.D. and James B. Powell, M.D., respectively, are long gone. The perspective these pathologists brought to these companies, as significant owners and high-level executives, has also vanished and has not been replaced in a comparable manner.

It is a similar story at **AmeriPath** and **IMPATH**. Pathologists and lab people initially played a key role in the launch of these public companies. But as the years passed, the ownership interest and executive-level involvement of pathologists was diminished.

Pathologists Own ARUP

In contrast, **ARUP Laboratories** of Salt Lake City, Utah represents an example of a significant pathologist-owned and pathologist-led national lab company. As such, it brings a different business philosophy to the marketplace than its non-pathologist-owned competitors.

This difference in philosophy is recognized across the hospital lab marketplace. Even where hospital labs do not use ARUP for send-out testing, lab directors and pathologists generally have positive things to say about ARUP's business philosophy versus its competitors. The belief is that pathologist-entrepreneurs understand the needs of clinicians better than non-technically trained laboratory executives.

It is also widely-recognized that ARUP is a profitable, growing, and dynamic company. Thus, with ARUP as a prominent example, why are so few pathologists willing to invest in their own business? Why are there fewer pathologist-entrepreneurs in this decade, unlike the 1970s and 1980s?

Lack Of Support & Nurture

On one level, it is a failure of the pathology profession's associations and trade groups to recognize, support, and nurture pathologists who might assume an entrepreneurial role. At one time, the **American Pathology Foundation** (APF) was considered to be the best place for a business-minded pathologist to network and gain support for new pathology-based business concepts. But in recent years, few new pathology ventures have been associated with that group.

Pathology Service Associates (PSA), the national umbrella for state pathology business networks, was a promising source of proactive support for business-minded pathologists. But even PSA has yet to demonstrate that it can act as an incubator for launching promising business concepts centered on pathology services.

It is time that the pathology profession recognizes the high value that pathologist-entrepreneurs bring. To prevent its fate from resting in the hands of non-pathologist businessmen, leadership of pathology professional associations should develop active programs to identify and nurture the dwindling number of those aspiring pathologist-entrepreneurs among us today. **TDR**

Professional Investors Spot Opportunity In New Esoteric Testing Technologies

BACK IN 1995, IT WAS NOT PATHOLOGISTS and trained laboratorians who created **Esoterix, Inc.** as a vehicle to offer complex esoteric testing to the healthcare community.

"Esoterix is the brainchild of two brothers, Darryl and Grant Behrman," stated James A. McClintic, President and CEO of Esoterix. "They are professional investors and operate **Behrman Capital**. Prior to Esoterix, they had little experience with the lab testing business.

"The Behrmans were looking for high-quality investment opportunities in three sectors: healthcare, services, and technology," explained McClintic. "They wanted to invest in businesses which emphasized cutting-edge science. In healthcare, this search quickly brought them to laboratory testing.

"As they toured laboratories around the country, the Behrman Brothers were impressed with both the science and the market potential of **Cytometry Associates** (Nashville, Tennessee) and **Endocrine Sciences** (Woodland Hills, California)," he continued. "They came up with a business plan that would preserve and boost the science offered by these types of specialty lab companies while creating a different kind of laboratory business organization."

Independent Lab Operation

Under this original business plan, the Behrmans envisioned acquiring successful specialty testing lab companies. Post acquisition, the lab company would retain its independence and would receive the capital and management support it needed to build its core business. Esoterix' corporate structure would remain lean and would function primarily to seek out and acquire additional specialty laboratories. The goal was to build size and scale—then go public.

"Under this business plan, Esoterix did eight more acquisitions," recalled McClintic. "But in 1999, revenues fell short of the projections needed to support an IPO (initial public offering). That's what led to a reassessment of our business plan in early 2000.

"In the strategic planning which followed, it was recognized that obvious synergies had not been harvested. For example, sending seven sales forces into the same client was counterproductive," he added. "It was also obvious that advances in information technology and the Internet could now allow us to support a "virtual laboratory organization."

Different Business Model

"With the financial support of the Behrmans, Esoterix altered its business model," McClintic said. "Complex and high-quality esoteric testing would remain its emphasis. Acquisition opportunities would still be pursued. But Esoterix would now centralize operational functions and build, from scratch, an IT system capable of allowing its network of specialty labs to function as a single entity, regardless of the geographical location of that lab."

In the three years since that strategic planning exercise, Behrman Capital has supported the investment of $50 million into Esoterix. It sees the potential of diagnostic testing and is willing to judiciously provide capital necessary to build and improve its laboratory organization.

The story of how Esoterix was created illustrates a simple truth about the pathology profession. Too often it is outsiders who see the opportunities to build a flourishing business from laboratory testing. Many pathologists, despite their ardent belief that lab testing has immense value to clinicians and the healthcare system, are reticent to invest their own money in their own business. That leaves the door open for non-laboratorians to come in and capture that value.

Acquisitions and Regulators Disrupt Status Quo

Changes Expected in Market For Hospital Reference Testing

CEO SUMMARY: For the hospital send-out testing marketplace, 2002 has been an eventful year. First came the acquisition of American Medical Laboratories by Quest Diagnostics Incorporated. In April, Specialty Laboratories disclosed its problems with state and federal laboratory regulators. A few months later, Premier announced that Laboratory Corporation of America was now the third lab provider on its national reference testing contract. Collectively, these and other developments have stimulated many hospital lab clients to rethink their existing send-out arrangements. As a result, competition for reference and esoteric testing has already intensified.

HOSPITAL SEND-OUT TESTING has become the most hotly-contested segment of the laboratory industry in recent years.

At the end of 2001, there were six major lab companies recognized in the first rank of reference and esoteric testing sources for hospitals and other types of clients. Behind this first rank of competitors is a growing number of specialty laboratories also seeking their own pieces of the send-out testing pie.

Because reference and esoteric testing is so lucrative when compared to the profit margins from routine chemistry and hematology testing, the nation's largest laboratory companies have made it a target. That means hospital administrators and pathologists will see intensified marketing efforts by **Laboratory Corporation of America** and **Quest Diagnostics Incorporated**. Both companies want to expand their share of hospital send-out testing.

Upset Competitive Status Quo

Since the beginning of 2002, several key events have upset the competitive status quo. On February 7, Quest Diagnostics announced it would acquire **American Medical Laboratories, Inc.** (AML). A few months later, on April 15, **Specialty Laboratories, Inc.** disclosed that lab regulators from California and the federal government had levied sanctions against it for non-compliance with CLIA-88 requirements. *(See TDRs, February 18 and April 22, 2002.)*

Late this summer came the next market-altering event. LabCorp was selected by **Premier** to join Quest Diagnostics and **ARUP Laboratories** as the third lab company on Premier's national reference testing contract.

All three developments changed the competitive environment. Each is causing many hospital laboratories to reassess existing business relationships with reference and esoteric laboratories. The impact of these competitive changes will reverberate for several years to come.

The events affecting AML and Specialty Laboratories in 2002 did not surprise long-time clients and readers of THE DARK REPORT. It was back in 1999 when we declared that competition in the hospital send-out market was about to intensify. In particular, THE DARK REPORT predicted that newer lab players would aggressively use discounted pricing to capture market share from the more established reference lab competitors.

In 1999, the two newest competitors were AML, which ramped up its marketing to hospital labs following its acquisition by new owners in 1997, and Specialty Labs, which expanded its own marketing to hospital labs in the mid-1990s. Since 1999, both lab companies demonstrated a willingness to offer extremely low prices to win new hospital lab clients.

During the past three years, both labs used aggressive pricing to capture substantial numbers of new accounts. Measured by growth in specimen volumes, that business strategy was successful for AML and Specialty, at least in the short term.

Downside Of Low Prices

However, what befell both these labs during 2002 shows the downside to their "low price" growth strategy. First, a look at AML. It spent heavily on sales and marketing to acquire new hospital reference testing business at relatively low prices. As a result, AML could not generate enough operating profit to pay down maturing debt, handle interest payments, and sustain the company through its next growth phase.

In late 2000, AML was unable to raise capital from a public offering. In the fall of 2001, it attempted another IPO (initial public offering). Without more capital it faced a difficult future. In December 2002, Quest Diagnostics launched acquisition talks with AML's biggest stockholder that led to its acquisition agreement in February.

Thus ended the relatively short business life of AML as an independent national reference laboratory provider. Despite impressive gains in specimen volume and revenue, its low pricing on that new business was not adequate enough to sustain the debt-laden lab company.

Different Impact At Specialty

The low-price business strategy at Specialty Laboratories played out in a different way. Specialty Labs was profitable and, unlike AML, virtually debt-free. After its IPO in late 2000, Specialty had upwards of $70 million of cash to fund its business activities.

However, since Specialty Labs was bringing on new testing business at low prices, it needed to carefully keep costs in line with revenues. Informed speculation is that management, trying to control costs even as it needed to cope with growing volumes of tests, neglected to invest the time and money required to maintain the type of high-level compliance assumed to exist at most esoteric testing laboratories.

Quality does cost money. Every laboratory in the United States understands the costs involved in running additional controls and taking extra steps during the testing process to insure an accurate test result. Because quality is not equal from lab to lab, that is why every laboratorian has an opinion on which "high quality" labs would be allowed to do critical tests on his/her spouse and children and which would not.

Regional Lab Networks

The travails at AML and Specialty are certainly a predictable outcome from the strategy of using low prices to build specimen volume from hospital send-out testing. The consequences of those decisions made in 1999 are now visible in 2002. Going forward, AML is gone and Specialty Labs faces tough, skeptical scrutiny as it works to restore its reputation.

Quest Diagnostics and LabCorp have been quick to seize competitive advantage from the problems at AML and Specialty. Both national lab behemoths are using these events to bolster their resources and ramp up sales and marketing to hospital labs.

The events of 2002 have also been good to **ARUP Laboratories** and **Mayo Medical Laboratories**. Both companies continue to enjoy a reputation for high quality service at a fair price—but not the lowest price. During 2002, ARUP and Mayo picked up considerable amounts of new business, as many hospital labs reassessed existing send-out relationships.

Competition To Intensify

But even as ARUP, Mayo, and **Esoterix** are benefiting from the changes taking place at AML and Specialty Labs, the two blood brothers are preparing to compete more intensely for hospital send-out testing.

Quest Diagnostics used the purchase of AML as the trigger for a major overhaul of their existing hospital reference testing program. *(See sidebar on page 12.)* It's worked hard to retain the key individuals responsible for AML's sales and marketing success in the hospital segment.

Quest Diagnostics is also converting AML's Chantilly laboratory into an east coast esoteric testing facility comparable to its Nichols Institute facility on the west coast. In fact, the two laboratories will now be called "Quest Diagnostics Nichols Institute San Juan Capistrano" and "Quest Diagnostics Nichols Institute Chantilly." Last week the AML signage at the Chantilly lab was removed and replaced by new signs that include the Nichols Institute Name.

Even as Quest Diagnostics was busy absorbing AML into its national lab system, LabCorp was engaged in discussions with Premier and emerged as the

Inside Story Behind Quest Diagnostics' Acquisition of American Medical Labs

NEWS THAT QUEST DIAGNOSTICS INCORPORATED would acquire **American Medical Laboratories** (AML) last January triggered a sequence of events which led to subsequent acquisition agreements between Quest Diagnostics and **Unilab** (in April) and between **Laboratory Corporation of America** and **Dynacare** (May).

In the months since the AML deal became public, THE DARK REPORT has gathered information from a host of sources about these three deals. The most interesting story involves both the motives and the timing behind Quest Diagnostics' purchase of AML.

Quest Diagnostics actually bought AML as a way to solve several business problems. First, on the physicians' office side of the ledger, Quest Diagnostics had lost a major managed care contract in Baltimore during the summer of 2001. When the **MAMSI** contract converted to LabCorp in August 2001, the resulting decline in specimen volume in Quest's Baltimore lab facility that fall forced Quest Diagnostics to radically downsize the Baltimore facility and lay off many employees at that site.

Replacing Lost Specimens

Because AML had considerable specimen volume from docs' offices in its Washington, DC and Las Vegas lab divisions, Quest could replace the volume lost from Baltimore. Of equal importance, by closing the AML deal early enough in 2002, it could minimize the visible impact that the lost Baltimore specimens would have on its public financial statements.

On the hospital send-out testing side of the ledger, Quest Diagnostics had some equally serious problems that the AML acquisition could help solve. Following its purchase of **SmithKline Beecham Clinical Laboratories** (SBCL) in 1999, Quest Diagnostics did an admirable job of integrating the two companies and retaining the business it had purchased. However, the one area where client retention efforts proved disappointing was in hospital send-out testing. Multiple sources tell THE DARK REPORT that, in the years following the SBCL acquisition, Quest Diagnostics lost as many as 600 hospital reference accounts.

Successful Competitor

Moreover, evidence indicates that AML was extraordinarily successful at stealing business from Quest Diagnostics. As many as 400 of these lost Quest accounts may have ended up as AML clients. This sets the stage for the next revealing fact.

Until this summer, **ARUP Laboratories** and Quest Diagnostics were the only two lab companies on **Premier, Inc.'s** national reference test contract. Multiple sources tell THE DARK REPORT that, on Premier's customer satisfaction surveys, ARUP consistently scores in the high 80s. In contrast, Quest Diagnostics has scored consistently in the low 40s—a customer satisfaction score less than half of ARUP's!

Premier had made its dissatisfaction with this performance known to Quest Diagnostics. To reinforce this point, last February, Premier was ready to publicly announce it had inked an agreement with a third laboratory company for its national reference testing contract. The new laboratory provider was to be American Medical Laboratories. Several sources tell THE DARK REPORT that this contract was expected to feature measurably lower prices for lab testing, as well as some unprecedented performance clauses (with financial penalties) for such measurable service elements as turnaround time.

But that was not to be. The day before Premier was scheduled to finalize its agreement and announce the addition of AML to its national reference testing contract, Quest Diagnostics announced it had signed an acquisition agreement with AML.

This timing was not accidental. Sources tell THE DARK REPORT that Quest Diagnostics had grave concerns about the addition of AML

continued on next page...

Quest-AML: Inside Story *continued...*

to the Premier national reference testing contract. Having lost significant send-out business to AML already, Quest Diagnostics was worried that, once AML was an approved Premier provider, it would continue raiding Quest's portfolio of hospital clients. Moreover, AML would offer more attractive pricing to hospital labs than what Quest offered under its Premier contract.

Buy The Tough Lab Competitor

But Quest could solve all these problems with a simple act: purchase AML and remove it as a competitor. Unintentionally, AML helped in the timing of its acquisition by Quest Diagnostics. As long-time readers of THE DARK REPORT know, AML carried lots of debt. *(See TDR, October 23, 2000.)* It needed considerable cash to pay off a current portion of its debt, as well as to make interest payments.

In the fall of 2001, it was testing the market for another try at a public stock offering. Thus, just at the moment when Quest Diagnostics wanted to purchase AML, it was "on the market." Many were surprised that Quest Diagnostics paid almost $500 million to get AML and its revenues of $300 million. But that price was a bargain for Quest Diagnostics when one understands how the AML acquisition could solve serious business problems plaguing Quest with both the physicians' office segment and the hospital send-out segment.

Adding A Third Contract Lab

The next chapter in this story was written by Premier. By acquiring AML and refusing to honor AML's commitment to Premier, Quest Diagnostics had removed it as the third provider on Premier's national reference contract. Premier was now denied the opportunity to offer its member hospitals a new, lower-priced lab option. Not surprisingly, an even unhappier Premier began negotiations with LabCorp. It announced that LabCorp would be its third national reference testing lab on July 15, 2002.

For lab administrators and pathologists seeking to understand the changes in the hospital send-out marketplace, this information provides a clearer insight into some of 2002's major events.

third lab provider on the national reference testing contract. That improves its ability to do business with the 1,700 hospital labs that are Premier members.

Taken collectively, changes triggered by the sale of AML and problems at Specialty Laboratories have scrambled the status quo among labs that compete for hospital send-out testing. In the short term, the beneficiaries have been ARUP, Mayo, and Esoterix. But the financial clout of Quest Diagnostics and LabCorp gives each sales advantages and economic strength which may make them even tougher competitors.

Specialty's Intentions

Meanwhile, Specialty Laboratories has cash reserves of $70 million and has emphatically declared that it intends to remain a major competitor. It will still use aggressive pricing as a lever to gain new accounts and protect its existing business.

What will be the outcomes from these changes? Unlike THE DARK REPORT's predictions in 1999 of competition based upon low prices by the newest lab competitors (at that time, AML and Specialty), the line-up in 2002 is different.

ARUP and Mayo will be the industry's Energizer Bunnies. They will keep on going and going and going... Esoterix is a wild card. After three years of restructuring and major capital investments, it's ready to compete at a higher level. But since it starts with a limited market share, its impact will be modest. Which leaves LabCorp and Quest Diagnostics. Because of their large size and national reach, it may be their game to win or lose. TDR

Reference Lab Rankings

Hospital Send-Out Testing
Ranked By 2001 Annual Revenue *($'s in millions)*

Rank	Laboratory	(in millions) 2001 Revenue	+/- from 2000
1.	**Quest Diagnostics Incorporated**[1] – *Teterboro, NJ*	$360.0	N/A
2.	**Laboratory Corporation of America**[2] – *Burlington, NC*	$210.0	+5.0%
3.	**Specialty Laboratories, Inc.**[3] – *Santa Monica, CA*	$175.2	+14.5%
4.	**American Medical Laboratories, Inc.**[4] – *Chantilly, VA*	$165.0	+14.6%
5.	**ARUP Laboratories, Inc.**[5] – *Salt Lake City, UT*	$160.0	+12.7%
6.	**Mayo Medical Laboratories, Inc.**[6] – *Rochester, MN*	$110.0	8.3%
7.	**Esoterix, Inc.**[7] – *Austin, TX*	$68.7	+14.5%
Total For Seven National Reference/Esoteric Labs		**$1,249.2**	**+7.2%**

Notes:

1) Quest Diagnostics reports esoteric testing was $472 million in 2001. It says it does not track hospital send-out testing as a separate category. THE DARK REPORT estimates that Quest Diagnostics did $360.00 million in hospital send-out testing during 2001.

2) LabCorp reports esoteric testing was $365 million in 2001. It says it does not track hospital send-out testing as a separate category. THE DARK REPORT estimates that LabCorp did $210.0 million in hospital send-out testing during 2001.

3) Source is public filings.

4) Estimated for hospital send-out testing only in 2001 and does not include its revenues from physician offices.

5) Source is ARUP Laboratories for fiscal year ending 6/30/2002.

6) Mayo Medical Laboratories declined to provide numbers. Estimate is based on corporate investment rating services and other sources.

7) Source is Esoterix and the numbers include direct physician testing services.

EDITOR'S NOTE — This is the fourth consecutive year that THE DARK REPORT has compiled these rankings. Each company had the opportunity to make corrections and provide additional input as appropriate. Several public lab companies do not track their hospital send-out business as a separate category. A variety of knowledgeable sources contributed input into creating a reasonable estimate of the dollar volume of hospital send-out testing done by these lab companies. These rankings indicate that the total dollar volume for hospital send-out testing in the United States remains under $1.5 billion per year.

Reactions To FL Court's Ruling On Clin Path Fees

Court says clinical path professional billing requires an advance disclosure to patient

CEO SUMMARY: Reimbursement for clinical pathology professional services is under attack in a variety of ways throughout the United States. Recently a Florida Court of Appeal added a new court ruling to the growing body of legal decisions on this topic. Careful study of the ruling shows that the court affirmed the role of the clinical pathologist, but wanted patients to understand this role before testing is performed and a bill is generated.

How does the July 12 ruling by Florida's Fifth District Court of Appeal impact long-standing procedures used by pathologists seeking reimbursement for clinical pathology professional services?

"Pathologists should be alert to the potential consequences of this litigation," stated Richard S. Cooper, a partner with **McDonald, Hopkins, Burke & Haber** of Cleveland, Ohio. "First, the ruling is a state court decision. Second, it may yet be appealed to that state's Supreme Court. Third, the ruling itself is a validation that pathologists in Florida who already have appropriate language included in the admissions package are probably legally well-positioned."

This case is known as *Central States, Southeast & Southwest, etc. vs. Florida Society of Pathologists, etc., et al*. Pathologists had gone to court and won an injunction in 2001 banning **Central States**, a health insurer, from advising patients that bills they receive from pathologists for clinical pathology professional services are "fraudulent" and should not be paid. Central States appealed, resulting in the Fifth Appeal Court's ruling on July 12 that delivered a mixed result to the pathology profession. *(See TDR, August 5, 2002.)*

Positive Aspect Of Ruling

"The Appeal Court decision has a positive aspect for pathologists," observed Cooper. "The court did not say that clinical pathology services were fraudulent or fictitious as argued by Central States. Rather, the court chose to focus on the contractual relationship that exists between patients and pathologists.

"In simplest terms, the Appeal Court decided that, if not notified in advance of these fees, the patient was not under an obligation to pay them," explained Cooper. "The Appeal Court studied the admission form presented to patients when they are admitted to the hospital and observed that 'we (the Appeal Court) see nothing in these forms that obliges a patient to pay a pathologist or anesthesiologist in the absence of a professional relationship with the pathologist or anesthesiologist.' The Appeal Court ruling seems to concentrate on whether or not the patient had prior notice of clinical pathology professional component charges.

"I must emphasize that this ruling is not binding in other jurisdictions," added Cooper. "As well, there are federal court decisions which affirm the right of pathologists to bill for clinical pathology professional component services. It is important to view this Florida case in the context of other legal decisions.

Legal Standing To Bill

"Having said that, we've recommended that our clients check the language used in admissions and outpatient registration documents of their hospitals," Cooper stated. "We consider this a reminder and an opportunity for pathologists to strengthen their legal standing with respect to professional component billing.

"If modifications or supplements to these materials would better address the concerns raised by this recent court ruling, pathologists should initiate discussions with their hospital administrators," he continued.

Registration Materials

"These materials should clearly explain that the patient may receive bills for the professional component of clinical pathology services and the patient is financially responsible for those services," stated Cooper. "Pathologists might want to include these materials, with a signature line for patient acknowledgement, in the forms used for hospital admission and outpatient registration.

"By doing this, pathologists establish a written contract with patients in advance of services. It meets the concerns expressed in the Florida Court of Appeal ruling," declared Cooper.

"I'd also suggest that pathologists, while undertaking to review the documentation in their hospital's admission and outpatient registration documents, consider adding language to their hospital contracts that obligates the hospitals to include this type of form in the hospital's admissions packages," added Cooper.

Sample Language To Use To Establish Relationship

AT A MINIMUM, Attorney Richard S. Cooper of McDonald, Hopkins, Burke and Haber recommends that pathologists include language of this type in hospital admission and outpatient registration forms:

"While you are in the hospital, you may receive anatomic or clinical laboratory tests directly performed by a pathologist. You may also receive clinical laboratory tests that will be performed under the supervision and direction of the pathologist, but are not personally performed by the pathologist. Although a pathologist may not perform these tests or personally review their results, the pathologist is responsible for the supervision and direction of the laboratory to insure that the performance of these laboratory tests and the results are appropriate. You may receive the a bill for these different types of pathologist services. By signing this form, you agree to pay the pathologist's charges for these services if your health plan does not cover all of the pathologist's charges."

No Widespread Changes

Within Florida, the ruling has caught the attention of the pathology profession, but seems to have stimulated few changes in billing practices. "In the eight weeks since this ruling was issued, not much has changed," noted Linda Liston, Director, Managed Care Services for **Per-Se Technologies Inc.**, a healthcare services company that provides outsourced business management services to clinical speicalties across the country, including pathology groups in Florida.

"Among our pathology clients, it's remained business as usual," she explained. "Pathologists in Florida are studying this decision, but we've seen no rush to make substantial changes yet. That's probably because there are still legal options that may yet change the final outcome of this litigation between Central States and the pathology community."

Liston also noted that Per-Se's role in sending bills involves the downstream part of the process. "For pathology groups in Florida, this court ruling focuses on the up-front steps before testing is done and a bill is generated. Since it is complex and time-consuming for hospitals to revise documents and implement new ones for the registration and admission process, I think most of our pathology clients in Florida are in a state of 'watchful waiting.' They want to see what the next step in the court process will be. At Per-Se, once a final decision is reached in this case, we will recommend an appropriate course of action for our clients."

Useful Insight

THE DARK REPORT observes that the Florida Appeal Court decision provides a useful insight for pathology groups seeking to improve their legal claim to billing for clinical pathology professional services, regardless of where the practice is located within the United States.

Pathologists can strengthen their legal position in regard to professional component billing by insuring that documents presented to patients at admission or outpatient registration include the type of language recommended earlier in this intelligence briefing. As Cooper noted, the only aspect of clinical pathology professional component the Florida Appeal Court could attack was whether or not the patient had a "contractual relationship" with a pathologist that he/she would never meet prior to performance of the lab tests.

By notifying the patient in advance, whether by using ABN-type of form in an outreach setting or having the right language included in hospital admissions or outpatient registration forms, pathologists are documenting their "contractual relationship" with the patient and strengthening their legal claim to be paid for clinical pathology professional services.

Sound Business Practice

From this perspective, the Florida Court ruling is simply emphasizing what was already recognized to be a sound business practice by some of the more savvy pathology groups within the United States. Over the years these groups have already incorporated similar language in documentation presented to patients before specimens are collected and lab tests are performed.

The next chapter in the litigation between Central States and Florida pathologists may involve a state Supreme Court review. That is one reason why pathology groups in Florida are in a mode of "watchful waiting."

However, it is important to view the efforts of Central States to cease payment for clinical pathology professional services as part of a larger battle. Across the United States, ever-growing numbers of payers and hospitals are willing to challenge the right of pathologists to be paid for these services. That is the more ominous trend. This Florida case is but one small battle in the ongoing defense of the pathologists' rightful claim to reimbursement for valuable services rendered. TDR

Contact Rick Cooper at 216-348-5438 and Linda Liston at 800-627-4726.

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

It's another sign of change that benefits clinical laboratories. The journal *Quality and Safety in Health Care* published a study recently which determined that 86% of mistakes in family care offices are administrative or process errors. Most involved misfiling patient information, *ordering the wrong tests*, or prescribing the wrong medication. Many of these errors would be eliminated by use of an effective electronic clinical information system. The study is one of the first to specifically study the sources of errors which occur outside a hospital. Laboratories would obviously benefit if more physicians ordered tests and received the results electronically.

HMOS' PROFITS CLIMB

Higher health premiums are boosting profits at insurers. News that health insurance prices climbed 12% in 2001 received wide play as the largest jump in 11 years. Now comes news that the S&P managed care index climbed 42% during the first half of 2002, showing that HMOs are much more profitable.

USE OF "PREDICTIVE MODELING" GROWS AMONG PAYERS

Health insurers like **Aetna**, **United Health Group**, **Cigna** and **Blue Cross/Blue Shield** are expanding use of "predictive modeling" software programs to identify beneficiaries who are likely to have health problems. The technology is widely used by weathermen and financial analysts. Health insurers plug in data on age, prescription drug use, claims data, and laboratory test results, among other factors, and the software program identifies individuals likely to have a health problem.

ADD TO: *"Predictive Modeling*

Laboratory test data plays a key role in predicting which individuals are likely to encounter health problems. Depending on the level of data available, companies claim these programs can accurately identify patients who will become ill 40% to 90% of the time. Although the companies say they only use predictive modeling to identify individuals who can benefit from preventive care, consumer advocates are concerned. They are worried about privacy violations in the use of the data and whether insurers might have a financial incentive to use the data to cull patients because they may generate higher medical costs in the future.

LABORATORIAN GETS TV CAMEO...

Recently the **Home And Garden** (HGTV) cable television channel featured a barn renovation done by Richard Novak and his wife Laura. Novak is Executive Vice President and COO of **Laboratory Corporation of America**. The Novaks moved an 1850s-era barn from New Jersey to North Carolina and renovated it into their residence. An 18-century West Virginia log cabin has also been moved onto the property.

That's all the insider intelligence for this report.
Look for the next briefing on Monday, October 7, 2002.