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From the Desk of R. Lewis Dark...

THE DARK REPORT

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

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COMMENTARY & OPINION by...

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California's Legal Challenge to Discount Pricing

PROBABLY NO TOPIC IN THE LAB TESTING INDUSTRY generates more controversy than discounted pricing for physicians, managed care companies, and IPAs (independent physician associations). Almost every pathologist and laboratory executive decries the corrosive effects of below-cost pricing.

Yet, many of these same lab executives quietly continue to solicit new clients by dangling deeply-discounted—and often money-losing—prices to physicians and health insurers. Competing labs recognize that often the prices are at marginal cost—which means that the lab doesn't recoup its fully loaded cost of performing the test. Sometimes a lab company will even offer prices that are less than the lab's marginal cost to perform the test.

The only way the lab can offer these money-losing prices is because it "pulls through" enough Medicare and other fee-for-service specimens to offset the losses incurred for testing the discount-priced tests. Typically it is national lab companies or investor-owned labs which are most willing to play this price game.

Local labs, hospital lab outreach programs, and pathology groups continously grumble about these business practices. Among these laboratory professionals, price discounting—particularly if the lab test price is less than the offering lab's marginal cost to perform the test—is seen as a form of inducement or kickback. The lab gives the discount for one part of the client's test referrals, and gains access to the Medicare and other fee-for-service specimens in exchange.

At the federal level, there has never been enforcement action that draws a clear boundary as to where a deeply-discounted lab test price falls on the wrong side of the law. That allows a number of laboratory companies to operate in the grey area, while labs with conservative compliance policies lose a competitive edge in the market. I point all this out because the deeply-discounted lab test pricing game might soon get a new set of rules in California.

Last year, Attorney General Jerry Brown unsealed the whistleblower lawsuit that alleges seven lab companies in California defrauded the Medi-Cal program. Now there is news that one laboratory has signed a settlement, and two others may have also settled. Brown argues that California state law requires a lab to bill Medi-Cal at the same lowest price for a test that the lab offers its other clients. If Brown gets the other four to six labs to settle and agree to bill Medi-Cal in this manner, then he may disrupt a long-standing lab industry practice in California. For that reason, the progress of this whistleblower suit bears watching. TDR

Westcliff Labs Announces BK and Sale to LabCorp

Chapter 11 bankruptcy reveals huge losses at what was once a profitable independent lab

CEO SUMMARY: Subject to court approval, Laboratory Corporation of America is poised to acquire the assets of California-based Westcliff Medical Laboratories, Inc., which just filed a Chapter 11 bankruptcy action in federal court on May 19. In a separate transaction, LabCorp has an agreement to acquire Diamond Reference Laboratory of Diamond Bar, California. The two acquisitions will build LabCorp's share of the market for laboratory testing in California.

IT IS LIKELY THAT THE CONCLUDING CHAPTER for **Westcliff Medical Laboratories, Inc.**, as an independent laboratory company is playing out in California. On May 19, Westcliff filed Chapter 11 bankruptcy and announced an agreement to be acquired by **Laboratory Corporation of America**.

It is an ignominious end to the third largest laboratory company serving physicians' offices in California. Its current owners failed to find a way to operate the company in a profitable manner, despite Westcliff's strong multi-year financial performance prior to its purchase by a private equity group in 2006.

Westcliff Medical Laboratories and its parent **BioLabs, Inc.**, filed a Chapter 11 bankruptcy petition on Wednesday, May 19. For the years 2008 and 2009, Westcliff reported eye-popping losses. In its bankruptcy petition, Westcliff said 2008 expenses and write offs totaled $171 million against total revenue of $83 million. This produced an $87 million loss for 2008.

That pattern continued in 2009. Westcliff stated that expenses and write offs totaled $110 million for the year. When posted against revenue of $97 million, the total loss was $13 million in 2009.

Thus, over the 24 months of 2008 and 2009, Westcliff generated $180 million in cumulative revenue. Against that, it incurred expenses and write offs for a cumulative total of $281 million!

Since 2009, Westcliff Medical Laboratory has shopped itself to potential buyers. As early as last fall, LabCorp was identified as willing to pay the strongest price for Westcliff. In its bankruptcy filing, Westcliff stated that it has entered into an

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asset purchase agreement (APA) with LabCorp.

To acquire Westcliff, LabCorp will pay $57.5 million for designated assets. Westcliff is keeping its accounts payable, which it believes will generate $8 million for the debtor estate in the bankruptcy.

Other Bidders For Westcliff

An upcoming step in the Chapter 11 bankruptcy action is for the court to solicit other bids for Westcliff Medical Laboratories. Westcliff stated that a successful overbid must exceed the $57.5 sales price negotiated with LabCorp by a minimum of $2.95 million. Were another bidder to step up and pay more for Westcliff, LabCorp is entitled to a $2.25 million break-up fee. LabCorp has already put $4 million of the purchase price on deposit.

Westcliff Medical Laboratories' senior secured debt totals as much as $56 million and **GE Business Financial Services, Inc.**, acts as the agent for the lenders. Westcliff stated that it has not been able to service this debt since early in 2009. Insiders say that GE has funneled between $10 million and $14 million of cash into Westcliff during 2009 and 2010 year-to-date to keep the laboratory afloat.

Debtors In Possession

Sometime in 2009, the holders of the senior debt became "debtors in possession" of Westcliff Medical Laboratories. These debt holders have placed at least two Chief Restructuring Officers (CROs) at Westcliff to represent their interests. On April 1, 2010, Matthew Pakkala become the current CRO. Pakkala is a Managing Director of **FTI Consulting, Inc.**, a company with headquarters in Baltimore, Maryland, and an office in Los Angeles, California.

One major roadblock that prevented an earlier sale of Westcliff Medical Laboratories by its current owners is the ongoing *qui tam* lawsuit against Westcliff and six other California laboratory companies involving claims that the laboratories systematically overcharged the Medi-Cal program (California's Medicaid program) by failing to offer Medi-Cal the lowest price for lab tests that they offer to physicians and other providers.

It was in April, 2009, when Attorney General Edmund G. Brown announced that California had joined this whistleblower lawsuit. The state is seeking to recover hundreds of millions of dollars in alleged overcharges. *(See TDR, April 6, 2009.)*

However, Westcliff stated in its bankruptcy documents that it has settled this lawsuit with the State of California. It said that an agreement had been signed on May 13, 2010—less than a week before the bankruptcy filing—that resolves these claims against it.

Medi-Cal Fraud Allegations

Westcliff described the allegations as follows: "By way of the *Qui Tam* Action, Plaintiffs and California asserted that, Westcliff submitted false claims for payment to Medi-Cal because Westcliff (1) charged Medi-Cal more for laboratory tests than Westcliff charged to other customers for the same laboratory tests, and (2) improperly offered discounts to other customers to induce them to refer more Medi-Cal business to Westcliff. Westcliff faces billions of dollars in potential liability in the *Qui Tam* Action."

At issue were 1,321,436 Medi-Cal claims submitted by Westcliff between November 1995 and December 31, 2008. As calculated by the Attorney General, this represented a claim of $56 million before any additional civil fines or penalties.

Because a civil penalty of between $5,000 and $10,000 for each alleged false claim could be assessed upon successful legal action, Westcliff acknowledged it faced additional fines that could reach between $6 billion and $12 billion. Until it could resolve this lawsuit, no buyer wanted to acquire Westcliff and assume this potential liability.

Westcliff's Path to Chapter 11 Bankruptcy

IT WAS JUNE, 2006 WHEN BIOLABS, INC., was created as a partnership between Parthenon Capital Holdings; Douglas Harrington, M.D.; and Dan Angress. BioLabs then acquired Westcliff Medical Laboratories of Santa Ana, California, and Health Line Clinical Laboratories of Burbank, California. The two laboratory companies were consolidated into a new, purpose-built lab facility of 80,000 square feet in Santa Ana.

After the summer of 2007, Harrington left as CEO, followed a few months later by Angress. Westcliff's owners assembled a new management team. Brian Urban, then Westcliff's CFO, took over as CEO. In the following months, Kip Vernaglia came aboard in the role of Senior Vice President of Sales and Marketing and by year's end Bob Whalen had become Chairman.

A timeline of significant events at BioLabs/Westcliff is presented on pages 9-13, along with information about the financial performance of the labortory company during the years 2006 through 2009. A string of disappointing financial results led BioLabs/Westcliff to file a Chapter 11 bankruptcy petition on May 19, 2010. Laboratory Corporation of America has entered into an agreement to acquire Westcliff's assets, subject to approval by the bankruptcy court.

Westcliff Medical Laboratories, Inc.
At-A-Glance

WESTCLIFF MEDICAL LABORATORIES, INC.

Acquired

2006 by BioLabs, Inc., (Health Line Clinical Laboratories acquired the same year and consolidated with Westcliff)

2008 Revenues:	**$92.5 million**
2008 Net Loss:	**-$87.0 million**
2009 Revenues:	**$97.3 million**
2009 Net Loss:	**-$13.0 million**

Volume:
9,700 requisitions daily

- Clinical lab reqs: **8,500 daily**
- Anatomic Path reqs: **1,200 daily**

FTEs:
1,000 (approx)

Patient Service Centers and Stat Labs:
170 locations

Clinical Laboratory:
80,000 sq. ft. in Santa Ana
(opened 2006)

Anatomic Pathology Laboratory:
12,800 sq. ft. in Monrovia
(opened 2008)

According to Westcliff, it will be released from the *qui tam* claims in return for putting $400,000 into an interest-bearing trust account to the benefit of California, the whistleblower, and the debtors. It will then pay 10% of the net proceeds from the sale of Westcliff's assets.

By completing the settlement agreement with the State of California on May 13 to resolve those liabilities, Westcliff Medical Laboratories removed one major hurdle to its sale. Westcliff's Chapter 11 bankruptcy filing, which took place six days later, was the required next step before its proposed acquisition by LabCorp can take place.

Swift Resolution Sought

Assuming that no other buyer steps forward and outbids LabCorp for the assets of Westcliff Medical Laboratories, Westcliff's existing owners are pressing the bankruptcy court for a swift resolution. LabCorp may take ownership of Westcliff's assets in as little as 30 days.

In a separate transaction, it has become known that LabCorp has also acquired **Diamond Reference Laboratories** of Diamond Bar, California. It is estimated that Diamond handles approximately 1,200 patient requisitions per day. By contrast, Westcliff handles 8,500 clinical laboratory requisitions daily.

Collectively, both acquisitions boost LabCorp's share of the clinical lab testing market in California. In fact, Westcliff told the bankruptcy court that it estimates the market for laboratory testing in California to be approximately $2 billion annually. With its almost $100 million in revenue per year, Westcliff estimates that it holds a 5% market share of lab testing in the state.

Already, pathologists and lab executives in California are speculating as to how LabCorp may consolidate testing across Southern California as it absorbs and integrates these two clinical laboratory acquisitions.

LabCorp's major testing facility is in San Diego. It has a smaller laboratory in Torrance, California, that was part of an acquisition early last decade. There is also the **US Labs'** facility in Irvine, California. It is known that this facility's lease will soon run out.

Lab Consolidation Options

Just down the road from the US Labs facility is the recently opened, 80,000 square foot laboratory operated by Westcliff. This gives LabCorp some interesting options as it takes ownership of Westcliff Medical Laboratories and Diamond Reference Laboratories and decides how to handle the space needs of its US Labs business unit.

It is also not known whether LabCorp will continue to use the Westcliff and Diamond names for any extended length of time following its acquisition of both laboratory companies. Clients of acquired laboratories are most prone to switch their business to competing laboratories in the months immediately following a laboratory acquisition. For that reason, in recent years, each of the two Blood Brothers have been more deliberate in their integration and consolidation of newly-acquired lab companies.

WestCliff As A Case Study

It may also turn out that the rapid financial decline of Westcliff Medical Laboratories between the years 2006 and 2010 becomes a classic business case study for the entire laboratory industry. Prior to its acquisition in 2006, Westcliff had a recognized, multi-year track record of sustained financial performance.

The period of 2006 and 2007 saw the new owners consolidate the operations of Westcliff with Health Line Clinical Laboratories. Then a new management team pursued different strategies in 2008 and 2009 that failed to produce profits at Westcliff. TDR

AG Jerry Brown Settles With Westcliff Med Labs

First look at the settlement agreement reveals how the AG may want labs to price tests to Medi-Cal

CEO SUMMARY: In California, Attorney General Jerry Brown is making progress in the whistleblower lawsuit alleging that seven lab companies in California violated state law by not giving Medi-Cal, the state's Medicaid program, the same lowest lab test prices they extend to physicians, managed care plans, and IPAs. Westcliff Medical Laboratories, Inc., is the first of the seven defendants to publicly acknowledge that it finalized a settlement agreement with the State of California.

When it filed its chapter 11 bankruptcy action, **Westcliff Medical Laboratories, Inc.,** of Santa Ana, California, disclosed that it had settled the outstanding whistleblower lawsuit against it involving claims that it defrauded Medi-Cal, California's Medicaid program.

Seven lab companies were named in the original *qui tam* lawsuit that was filed under seal in 2005 by **Hunter Laboratories, Inc.**, of Campbell, California, and its owner Chris Riedel. The lawsuit alleges that the seven labs violated California's False Claims Act in how they billed the Medi-Cal program.

Jerry Brown Joins Lawsuit

California Attorney General Jerry Brown announced the *qui tam* lawsuit in April 2009 and unsealed the case at that time. Brown has stated that he believes the seven medical laboratory companies named as defendants in the lawsuit "have siphoned off hundreds of millions of dollars from programs intended for the most vulnerable California families." *(See TDR, April 6, 2009.)*

Although the Westcliff settlement with the California Attorney General is the only one which has been made public, The Dark Report has learned that possibly two more laboratories named in the lawsuit have signed settlement agreements with the State of California. If true, it indicates that Attorney General Jerry Brown may hold stronger legal cards than previously thought.

Despite the legal precedents of several court cases in California during the past 20 years that ruled in favor of a laboratory company giving certain customers lower prices for lab tests than it did to the Medi-Cal program, Brown has apparently brought three of the seven laboratory companies to the table and negotiated a settlement agreement with them.

This has to be unsettling to the remaining four laboratories, which include **Quest Diagnostics Incorporated** and **Laboratory Corporation of America**. The political and social landscape may favor Brown's effort to pursue a maximum settlement with the remaining defendants in this *qui tam* case.

Jerry Brown's interest in this lawsuit comes at a time when his cash-strapped state is desperate for the funds needed to maintain essential state services, including the Medi-Cal program. This gives the gov-

ernment attorneys prosecuting the case strong motivation.

That is why news of the first settlements between the State of California and some of the defendants is a significant development. Brown has decided to challenge the widespread lab industry practice of extending deeply-discounted prices to physicians, managed care companies, independent physician associations (IPAs), and group purchasing organizations (GPOs).

State Enforcement Action

As the AG of a large state, Brown's action is without precedent in recent years, since most enforcement actions have come at the federal level. These federal actions have not done much to change the status quo for the common practice of deeply-discounted lab test pricing.

That may change if Attorney General Brown prevails in his effort to pursue this whistleblower case in court or resolve it with settlement agreements between California and each of the other laboratory companies named as defendants in the lawsuit. The hint of how Brown intends to challenge the wide-spread practice of California labs extending discounted prices to customers that are less than the Medi-Cal fee schedule can be found in the settlement agreement made public by **Biolabs, Inc.**, the owner of Westcliff Medical Laboratories.

The settlement agreement first establishes the point that "This Settlement Agreement is neither an admission of liability by Westcliff nor a concession by California or Qui Tam Plaintiffs that their claims are not well-founded. Westcliff expressly denies any such liability."

Later in the Westcliff settlement agreement, Attorney General Brown reveals his strategy to permanently change existing lab test price discounting practices in California. He is structuring the compliance requirements in a manner that is favorable to the Medi-Cal program and meets his interpretation of existing state law covering the pricing of health services by providers to other providers and to the Medi-Cal program.

Brown's strategy is simple. His settlement agreement doesn't prevent Westcliff from charging the lowest price it wants to any customer. It requires Westcliff to give Medi-Cal the very lowest price for that test that it charges to any client. Effectively, this positions Medi-Cal to be billed at the very lowest price that the lab company is offering to any of its customers.

To audit compliance, Westcliff, if it does not sell within 360 days, will submit a report every six months to state officials that must list "all purchasers who were charged less for any Laboratory Test than Westcliff or Biolabs was paid by Medi-Cal for the same Laboratory Test during the same reporting period ('Lower Price Purchasers')... after giving full effect to all offered, agreed, or regular rebates, adjustments, discounts, write-offs, services, and other allowances and consideration of any kind."

Moreover, "...It is agreed that neither monthly billing, nor volume of Laboratory Tests done by the purchaser, nor indigency of the patient for whom the Laboratory Test is done *shall be used as reason not to charge Medi-Cal at least as low a price.*" (Italics by THE DARK REPORT)

Capitated Payment Formula

A formula for capitated contracts obligates Westcliff to calculate a discount percentage, then, "...If the total capitated payments are less than the calculated Medi-Cal fees, the percentage discount will be applied equally to all Laboratory Tests billed to Medi-Cal for that period and a refund to the Medi-Cal Program will be required within 30 days."

Pathologists and clinical laboratory administrators will recognize how Brown's approach to enforcing California Medi-Cal laws could radically change lab test pricing practices in the Golden State. That is one reason why the remaining lab defendants will expend substantial resources to defend themselves in this *qui tam* suit. TDR

Did Wrong Strategy Sink Westcliff Medical Labs?

California's third-largest commercial lab firm took just 46 months to slide into bankruptcy court

CEO SUMMARY: All sorts of people will argue all sorts of opinions about the financial demise of BioLabs, Inc., and its subsidiary, Westcliff Medical Laboratories, Inc., and why it ended up in a California bankruptcy court. Documents filed in the case indicate that, from the birth of the new company in June, 2006, it never produced an annual profit. During the 46 months of BioLabs/Westcliff's business life, its owners worked with two different management teams, each of which had a different strategy for growth.

FOR DECADES, **Westcliff Medical Laboratories, Inc.**, operated profitably in California's rough and tumble lab testing market. So why, just 46 months after it was acquired by new owners, did this commercial laboratory company end up in Chapter 11 bankruptcy court?

What may best illustrate Westcliff's remarkably rapid descent into bankruptcy court is the financial performance as disclosed in court papers. The company's 2008 statement shows that Westcliff had revenue of $92.5 million—but incurred expenses and write downs of $179.5 million. That produced a total loss of $87 million. In 2009, Westcliff's revenue totaled $97.4 million and it says it incurred expenses and write downs of $110 million, thus producing a total loss of $12.6 million for the year.

The financial unraveling of the long-respected **Westcliff Medical Laboratories, Inc.**, of Santa Ana, California—following its acquisition by private equity investors in 2006—has important lessons for the entire clinical laboratory industry. It is a story that also can be instructive to the professional investment community about the challenges of acquiring and operating commercial laboratory companies.

On the following pages, THE DARK REPORT attempts to provide a timeline of events that unfolded within Westcliff Medical Laboratories between 2006 and the present. Over the past four years, the origins and business life of **BioLabs, Inc.**, and its Westcliff Medical Laboratory subsidiary have been the subject of hearsay and widespread misconceptions throughout the California laboratory community. It benefits the laboratory profession to have a more complete public record of what happened at Westcliff.

Timeline For Westcliff

The timeline which follows was assembled from a variety of resources. This includes conversations with a number of individuals who claimed knowledge of events at Westcliff, along with source documents that have become public. Calls by THE DARK REPORT to Westcliff Medical Laboratories had not been returned as of press time. That means the following timeline has no input from the current executive team and owners.

Readers should be aware that, among the sources consulted in the effort to create the following timeline about Westcliff

Medical Laboratories from 2006 through 2010, there were differing opinions and perceptions. THE DARK REPORT recognizes these differences in opinion and is open to presenting those perspectives or correcting any factual inaccuracies when presented with appropriate and credible evidence.

For clarity, the timeline will be presented as chapters. The emphasis will be on known facts, often sourced from Westcliff's court filings.

Chapter One: The Creation of BioLabs, Inc.

During 2006, BioLabs, Inc. was created as a partnership between **Parthenon Capital Partners**, Doug Harrington (as CEO), and Dan Angress (as COO). On June 30, 2006, BioLabs acquired Westcliff Medical Laboratories and **Health Line Clinical Laboratories, Inc.**

BioLabs paid approximately $79 million for Westcliff, which included about $6 million in transaction costs. Westcliff's former principle shareholder invested $10 million in convertible preferred stock in BioLabs. It is estimated that Westcliff's annual revenues were around $60 million.

BioLabs paid approximately $25 million for Health Line. The former principle shareholder of Health Line invested $4 million in convertible preferred stock in BioLabs. It is estimated that Health Line's annual revenues were around $25 million. BioLabs/Westcliff started its corporate life with about $42.6 million in long-term debt.

Chapter Two: 2006-Mid 2007: Integrating Two Labs

Over the next 14 months, under the name Westcliff Medical Laboratories, BioLabs consolidated the testing operations of the two laboratories into a new, 80,000 square foot lab facility in Santa Ana.

In the summer of 2007, BioLabs acquired **Clinical Pathology Laboratories, Inc.**, of Antelope Valley, California. The purchase price was about $2.0 million.

Based on Westcliff Medical Laboratories' financial statement for 2006 and 2007, it seems that the consolidation of the two acquired laboratories did not prove overly problematic. Net revenues for the last six months of 2006 were $44.3 million, which projects an annualized run rate of about $88.6 million. By contrast, in 2007 WestCliff's full-year net revenue was $84.3 million.

This would suggest that Westcliff might have lost about $4.3 million in revenue during 2007. It is known that the new owners had anticipated some client turnover, particularly from the Health Line book of business.

Westcliff posted operating losses of $712,000 in 2006 (July-December), compared to a $1.4 million operating loss in 2007. To service its debt, the company paid interest expenses totaling $2.3 million in 2006 and $4.8 million in 2007.

Net loss was $3.0 million in 2006 and $6.2 million in 2007. During 2007, Parthenon contributed $6.4 million in capital to fund the acquisition and for operating expenses.

The noteworthy management event during 2007 was the departure of CEO Doug Harrington late in the year. CFO Brian Urban assumed responsibilities as acting CEO. In the following months, Kip Vernaglia came to Westcliff in the role of Senior Vice President of Sales and Marketing. Both Urban and Vernaglia had worked together at **UniLab Corporation** prior to its acquisition by **Quest Diagnostics Incorporated** in 2003.

Chapter Three: Late 2007: Pump Up The Sales Program

During the last part of 2007, multiple sources indicate that the decision was made by Parthenon and its new executive team to adopt a strategy of growth in specimen volume and revenue as a way to return to profitability. Westcliff's court documents indicate that Bob Whelan assumed the position of Westcliff's

Westcliff Medical Laboratories' Performance Shows How Debt Can Affect Profit Margins

IN DOCUMENTS FILED WITH THE BANKRUPTCY COURT, BioLabs, Inc., and its Westcliff Medical Laboratories, Inc., subsidiary disclosed its financial performance from the date of the business launch on June 30, 2006 through the end of 2009. These financial results are summarized below in a simple format.

During the first three years, Westcliff's operating expenses and costs exceeded revenue. Only in 2009 did the company's revenue exceed its operating expenses. The summary table also shows how the need to pay interest on the debt used by the new owners to acquire Westcliff and Health Line was a significant drain on cash flow.

Key Financial Data Points for Westcliff Medical Labs

	2006–6 Mths*	2007	2008	2009
Net Revenue	$44,308,105	$84,253,042	$92,460,717	$97,369,082
Operating Expenses	$45,020,692	$85,622,161	$102,427,322	$96,331,705
Operating Loss/Profit	-$712,587	-$1,369,119	-$9,996,605	$1,037,376
Interest Expense	$2,303,223	$4,818,100	$4,084,302	$4,610,211
Net Loss	-$3,006,607	-$6,178,151	-$86,980,609	-$13,206,381

** In 2006, Company operated from July 1 through December 31.*

Note: In 2007, Parthenon Capital Partners contributed approximately $6.4 million in capital to Westcliff. For 2008, Parthenon contributed an additional $18.0 million in capital to Westcliff.

Chairman before the end of 2007.

Several competitors selling against Westcliff have pointed out that—starting in the late months of 2007—the combination of Whalen, Urban, and Vernaglia adopted similar sales and marketing tactics at Westcliff to those they employed at Unilab in earlier years. At the core of this approach is the use of deeply-discounted prices and capitated rates to win managed care contracts and IPA (independent physician association) agreements.

Two assumptions underpin this sales strategy. First, that a low price for the managed care/IPA contract will win the business from competing labs. Second, that Westcliff's sales representatives can then use the network status of the managed care contract to persuade doctors to refer their Medicare and other fee-for-service specimens to Westcliff—these specimens representing the "pull-through" business. By blending the revenue from lower-priced managed care requisitions with the pull-through fee-for-service requisitions, there is then adequate cash to produce a profit.

Some outside observers claim to know of managed care contracts that Westcliff signed at rates as low as 45¢ per member per month (PMPM). They also state that Westcliff was often prepared to win new managed care and IPA contracts with prices at $1.00 PMPM or less.

The notable point here is that competitors recognized that, from this time forward, Westcliff adopted a sales policy that would have different financial ramifications compared to the sales strategy of the management team that ran Westcliff during 2006 and into 2007.

Chapter Four: 2008: Buying Labs, New MC Contracts

Sales activity accelerated at Westcliff throughout 2008, as the number of sales

reps in the field increases in tandem with the effort to bid for a larger number of managed care and IPA contracts than in 2006-07.

In March, 2008, Westcliff acquired **Southern California Reference Laboratory** in Tustin, California. The purchase price was about $3.5 million. Then, a month later, Westcliff acquired Riverside, California-based **NTI-Florida, Inc.**, (one of the business units of **United West Laboratories, Inc.**) for a price of approximately $2.0 million.

In October, 2008, Westcliff next acquired **The Laboratory Choice, LLC**, in Woodland Hills, California. The purchase price was about $2.0 million.

Notable dates in 2008 include August 14, 2008. That is the date Westcliff says it sent a notice of default to its long-term debt holders. Company financials indicate that about $5.3 million of its long-term debt was due that year. During 2008, Parthenon Capital Partners pumped in another $18.0 million in capital for the lab acquisitions and operating expenses.

Financial performance for 2008 indicates that neither the three small lab acquisitions nor the intensified sales campaign were relieving the financial pressure. Court documents include a 2008 financial statement.

BioLab's Acquisition History

BIOLABS, INC. WAS CREATED IN 2006 and immediately acquired Westcliff Medical Laboratories, Inc., and Health Line Clinical Laboratories, Inc., as the first step to implement its business plan. During the next 30 months, BioLabs was an opportunistic acquirer of smaller lab companies in Southern California. The information below was taken from company documents.

DATE	LABORATORY	APPROX. PRICE (MILLIONS)
Jun-06	Westcliff Medical Laboratories	$79.0
Jun-06	HealthLine Clinical Laboratories	$25.0
Jul-07	Clinical Pathology Laboratories	$2.0
Mar-08	Southern California Reference Lab	$3.5
Apr-08	NTI-Florida, Inc.	$2.0
Oct-08	The Laboratory Choice, LLC	$2.0

Westcliff's total revenue was indeed higher, hitting $92.5 million in 2008, compared to $84.3 million in 2007. However, Westcliff's operating loss in 2008 was $10 million, an increase compared to the previous year's operating loss of $1.4 million.

Assuming that the new sales strategy—along with the three lab acquisitions during 2008—was adding specimen volume and revenue, Westcliff saw a significant increase in expenses. For 2008, Westcliff's total operation costs and expenses were $102.4 million, in contrast to expenses of $85.6 million in 2007. This was a $16.5 million increase in costs during that 12 months.

So, against a growth in net revenue of $8.2 million during 2008, Westcliff's operating expenses and costs increased by $16.8 million. One way to look at this is to say that the company was spending $8.6 million more in operating expenses to support these additional sources of revenue that were brought in by the new lab acquisitions, the new managed care contracts, and the new clients. That is a simplistic analysis and does not reflect other undisclosed factors at Westcliff during 2008.

Another significant development at Westcliff during 2008 was the decision to write down its accounts for goodwill and intangibles. Collectively, the two accounts totaled $106.5 million in 2007. Apparently the owners and management team believed these assets were severely impaired. They decided to write them down to a combined total of just $29.4 million at the end of 2008.

This produced a net loss at Westcliff of $87.0 million for 2008, compared to a net loss of $6.2 million in 2007.

➤➤➤ Chapter Five: 2009: Looking For A Solution

With the advent of 2009, owners and the executive team at Westcliff were looking for ways to resolve the issues facing Westcliff Medical Laboratories.

During the year, it is known that the debtors sent a Chief Restructuring Officer (CRO) to Westcliff to represent their inter-

est. The consortium of lenders also provided additional working capital to sustain the business until the business could be sold or put into bankruptcy. In July, 2009, court papers indicate that Bob Whalen became CEO in addition to his role as Chairman.

After shopping Westcliff to prospective buyers, **Laboratory Corporation of America** surfaced as an interested buyer. Those negotiations eventually led to the purchase agreement disclosed in the Chapter 11 bankruptcy action initiated on May 19, 2010.

For 2009, Westcliff's revenue increased to $97.4 million, compared to $92.5 million in 2008. One positive sign was that operating expenses and costs declined from the $102.4 million level in 2008 to $96.3 million in 2009. That produced positive cash flow of $1 million.

However, because of the sizable debt and other non-recurring expenses, Westcliff's total loss for 2009 was $13.2 million. One interesting observation is that non-recurring legal expense reached $1.7 million during the year—a sign that Westcliff's lawyers were very busy during the year.

Chapter Six: 2010 YTD: Chapter 11 Bankruptcy

Having negotiated an agreement to be acquired by LabCorp, Westcliff Medical Laboratories needed to resolve the *qui tam* lawsuit alleging that it had defrauded Medi-Cal, the California Medicaid program, for lab claims submitted in earlier years.

That resolution was achieved with an agreement signed on May 13 with the State of California. Removal of that hurdle enabled BioLabs/Westcliff to file its bankruptcy petition just six days later, on May 19, 2010.

For the first four months of 2010, documents circulating to potential bidders disclose that Westcliff's net revenue totaled $33.7 million, against operating expenses of $32.9 million. This produced a positive cash flow from operations of $876,000 for 2010's first four months. However, this positive cash flow was too little and too late to affect the owners' decision to file bankruptcy and sell BioLabs/Westcliff.

The Tale In The Financials

There are several obvious facts that emerge from a study of Westcliff's financial documents. One, starting in the first six months after the change of ownership in 2006, the new owners found it difficult to balance revenue against operating expenses to produce cash flow—the EBITDA (earnings before interest, taxes, depreciation, and amortization required to be a financially self-sustaining business.

Two, the level of long term debt the owners used to buy Westcliff and Health Line placed a heavy strain on the new company. That is most visible in 2006 and 2007, when operating losses of $700,000 and $1.4 million grew to net losses of $2.3 million and $4.8 million in 2006 and 2007, respectively. The need to service this debt was a challenge to both management teams backed by the owners during the 2006-2010 period.

Sales Strategy At Westcliff

As to the success of the sales and growth strategies adopted by the executives who arrived at Westcliff late in 2007, there are already vigorous defenders and vociferous critics. They are likely to argue far into the future as to how well the managed care contract acquisition/pull-through campaign played out at Westcliff.

However, the basic financial information for Westcliff's financial performance for the years 2006 through 2010 that is presented on these pages should prove helpful to those pathologists and laboratory executives who want to use BioLabs/Westcliff as a lab management case study. That would be consistent with the advice of English Prime Minister Edmund Burke (1729-1797) who said "Those who don't know history are destined to repeat it." TDR

Taming the Blood Beast With Better Utilization

➤Rapid yearly increases in blood product cost motivates hospital labs to educate physicians

➤➤CEO SUMMARY: For hospital labs, explosive increases in the cost of blood products is a budget buster. At St. Vincent Indianapolis Hospital, a multi-year blood management program is paying big dividends. Patient safety has improved, even as utilization of blood dropped by 7,000 units per year. Annual savings from this innovative blood management program now total $4 million. One key element behind this succes was for the lab to engage and educate physicians in a multi-disciplinary approach.

BURNING A BIG HOLE IN THE BUDGETS of hospital laboratories across the nation are the costs of transfusion services and blood banking.

Hospital and health system laboratories are facing a perfect storm of rising expenses. Over the past decade, each year brought hefty price increases for blood products. At the same time, labs were expected to intensify management of transfusion services and the blood bank, with the goal of improving patient safety and reducing unnecessary use of blood products.

➤Blood Product Management

"It's no surprise that blood products and transfusion services are becoming management priorities for hospital laboratories," stated anesthesiologist Timothy Hannon, M.D., MBA, Medical Director of the Blood Management Program at **St. Vincent Indianapolis Hospital** in Indianapolis, Indiana. He is also President and CEO of **Strategic Healthcare Group LLC**, a blood management consulting firm.

"For the moment, set aside the huge costs associated with the use of blood products," continued Hannon. "New research and ongoing studies provide a powerful case in favor of much tighter guidelines for use of blood products by physicians.

"There are two primary aspects to the blood product management challenges facing hospital labs today," observed Hannon. "First, a significant portion of the blood units used in treatment today are likely wasted because many physicians do not understand the current clinical practices which govern how many units to have on hand, and how they should be administered to the patient during treatment. Beyond this knowledge gap, most hospitals don't have a workable surgical blood ordering schedule.

"Every pathologist is familiar with the situation of certain physicians who regularly order too many units," he said. "After surgery, it is not possible to put those unused units back into the blood bank. This is pure waste of an expensive and life-sustaining product.

"Second, clinical practices associated with the use of blood products are evolving rapidly," explained Hannon. "On the plus side, this new knowledge allows us to

be more evidence-based when treating patients. The benefit is improved outcomes for the patient with fewer instances of negative or harmful consequences associated with the administration of blood products to the patient.

"However, this good news comes with a challenge for pathologists and laboratory scientists," added Hannon. "Many physicians are unaware of these changing standards in clinical practice. It often falls to the laboratory to take a lead role in educating physicians about current standards of practice, which are much more conservative than in the past."

"Third, national data indicates a wide variation in practice," he noted. "This is true for different regions of the United States. It is also true of the individual physicians within a single hospital or health system.

"This variation was demonstrated in a report published in *Anesthesiology* in 1998," he said. "Blood use in primary coronary artery bypass grafts (CABG) was studied in 24 hospitals. It was determined that 92% of CABG patients received blood at one of the study hospitals, while only 27% of CABG patients received blood at another hospital.

Four-Fold Difference

"Primary CABG is first-time heart surgery," explained Hannon. "It is basically the same surgery, whether it is performed in San Diego or Indianapolis or New York. Yet, there is a four-fold difference in transfusion rates!

"What's even more disturbing to me as a physician is that—within an institution—there is also wide variation in practice, with some physicians being very liberal, others being very conservative," he said.

Hannon noted that a 10-year follow up study in 2008, published in *Transfusion*, showed even wider variations in red blood cell usage in cardiac surgery among 16 developed countries. Usage rates ranged from about 10% to 100%.

"That degree of variation in what should be a fairly standardized practice is symptomatic of a poorly-controlled process," observed Hannon, who then pointed out that the variation is not just in cardiac surgery. Studies of blood use done in other fields, such as orthopedics, trauma, and oncology, have found equally broad variations in practice.

"There is another interesting phenomenon," commented Hannon. "During the past 10 years, blood use has increased in the United States, while blood use has stabilized or even dropped in most other developed countries. Currently, blood use in the U.S. is 15% percent higher than use in Europe and 44% higher than in Canada on a per capita basis."

Change In Blood Use

Hannon also called attention to the fact that transfusion has shifted to a different set of patients. "At my hospital, St. Vincent's, in 2001 our number one consumer of blood products was cardiac surgery. It used almost 35% of our blood, with oncology using 22%.

"Today, in 2010, those numbers have flipped," he noted. "Our number one user of blood is oncology, while cardiac surgery is a distant second. Primarily, this change is due to our intense and ongoing efforts in recent years to encourage better blood conservation in surgical patients, along with the increasing use of blood products in medical and oncology therapy.

"For labs, it means that blood management efforts cannot focus exclusively on the peri-operative area," Hannon said. "There must be strategies for both surgical and medical patients, along with the outpatients. At our hospital, 20-25% of transfusions are now given to outpatients, meaning this is another target-rich opportunity."

Frequent Complications

Hannon noted that over-use of blood is related to the perception of physicians that blood transfusions are safe and have few side effects. "While the chances for infectious viral transmission are low—about 1 in 2 million—other non-infectious com-

plications occur much more frequently," he stated.

As an example, Hannon referred to a 1999 study in *Transfusion* which found that, as the number of units of blood given increases, the risk for pneumonia and serious bacterial infections also increases.

Length Of Blood Storage

"Some of these complications are associated with the length of blood storage, since 'older blood' has been associated with poorer outcomes," he explained. "The threshold for increased risk of complications appears to come from blood stored longer than 14 days, although the evidence to date is not definitive and formal studies are just being constructed."

For pathologists and laboratory administrators who are ready to tackle the twin challenges of increased cost of blood products and variation in practice within their hospital or health system, Hannon has advice based on the successful blood management program at 747-bed St. Vincent Indianapolis, which he designed and implemented.

"Since launching our blood management program in 2001," recalled Hannon. "we've achieved a 30% sustainable reduction in hospital transfusions. That means we use 7,000 fewer units of blood each year and that generates $4 million in savings annually at our hospital!

Appropriate Blood Use

"An effective blood management program needs to address two issues," he offered. "One issue is how we decide to give blood to an individual patient. The second issue is to reduce the number of patients who are transfused in the hospital through proactive management strategies, since we know that the greater the number of units of blood, the greater the total cost of care and the greater risk of transfusion-related complications.

"Frankly, I don't care if my hospital uses more blood than another hospital, as long as the blood is used wisely, appropriately, and in an evidence-based manner," he said. "The heart of stewardship of this community resource is appropriate utilization. Unfortunately, the current practice habits of many physicians means that the deck is stacked against appropriate use."

Hannon's consulting firm, Strategic Healthcare Group, has reviewed more than 3,000 patient charts in a number of hospitals over the past three years. "Our composite score for appropriate use of blood products for all of those hospitals is about 50%," he stated. "This evidence supports my argument that, any time a unit leaves the hospital blood bank, it's a coin-toss as to whether the decision to use that blood is appropriate."

Other studies of blood product use confirm Hannon's observation. Similar or even worse results were identified when hospitals were audited for the appropriateness of blood use. An audit of routine transfusion orders at **Brigham and Women's Hospital** in Boston found that 73% of orders were inappropriate. Another recent audit of two New York City hospitals showed 62% of transfusion orders were inappropriate.

Overuse Of Blood

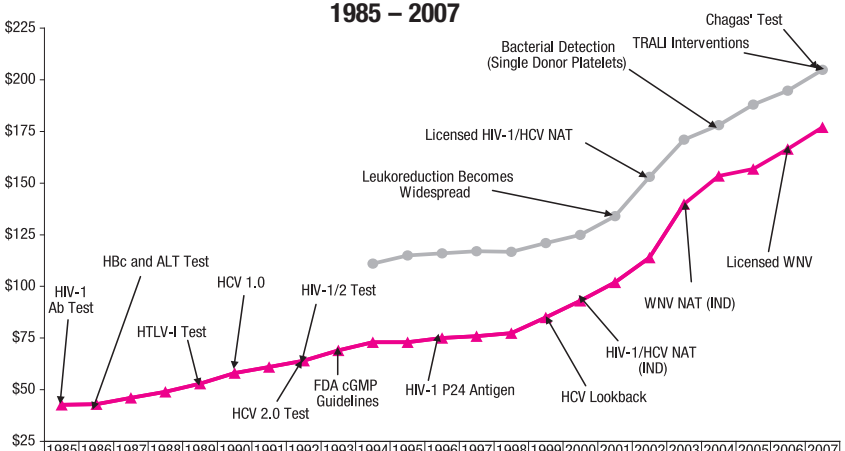
"Don't forget that, beyond the patient safety aspect, such overuse of blood has serious consequences for local blood supplies as well as for a hospital's bottom line," commented Hannon.

Hannon advises that hospital laboratories need to understand the total costs associated with the use of each unit of blood. "The purchase price of the blood used in a transfusion is only one portion of the overall cost," he stated. "The cost skyrockets when you factor in staff time used for ordering blood, managing blood storage, administering and documenting transfusions, and treating adverse effects.

"Typically, a $220 unit of blood costs about $2,100 to administer," noted Hannon. "This is why better blood man-

Cost of Blood Products Spirals Upward, Variation in Utilization is Significant

America's Blood Centers
Safety Measures and Median Red Cell Service Fees
1985 – 2007



	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
RBCs	$43	43	46	49	53	58	61	64	69	73	73	75	76	77	85	93	102	114	140	154	157	166	177
RBCs, LR										$111	115	116	117	117	121	125	134	153	171	178	188	195	205

Source: Indiana Blood Center

Rapid and continual increases in the cost of fees for blood products from 1985 through 2007 is shown in the chart presented above. Since 2000, the annual rate of cost increases moved to a significantly higher figure. The information below illustrates how blood utilization trends in the United States differ from blood utilization trends in other countries.

Blood utilization trends United States vs. International

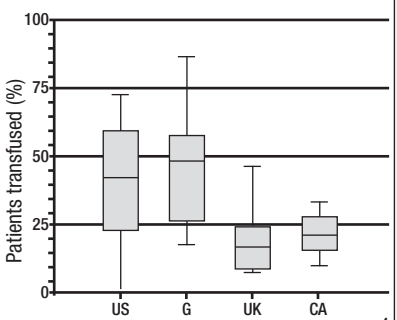
- **Universal blood use trends are shifting from surgical to medical patients[1]**
  - –Better surgical blood conservation
  - –Aging medical and oncology population
- **During the period 1999-2004[1,2]:**
  - –Blood use in the U.S. increased by 16%
  - –Blood use in the U.K. declined by 8%
- **Current per capita blood use in the U.S. is[3]:**
  - –15% higher than in Europe
  - – 44% higher than in Canada
- **Do we really have older, sicker patients in the United States than in the rest of the world?**

[1]Wallis et al, Trans Med 2006; 16
[2]Yazer, Transfusion 2007; 47
[3]McPherson, Transfusion 2007; 47S
[4]Snyder-Ramos, Transfusion 2008; 48

TABLE 1. Medical benchmarks[3]

RBC use per 1000 population (2005)	
Australia	37
Canada (CBS*)	32
Europe	40
United States	46

* CBS=Canadian Blood Services.



Cardiac surgery intraoperative RBC transfusions.[4]

agement translates into better patient safety and substantially lower costs.

"In fact, it is reasonable for any hospital to see a 10% to 30% savings in the cost of transfusion services and blood products during the first year of a concentrated program to improve utilization," he added. "These savings come in tandem with improvements in patient outcomes and patient safety as physicians use blood products more appropriately."

Based on the 10-year experience with the blood management program at St. Vincent Hospital, as well as direct experience with 40 other hospitals and health systems, Hannon has several recommendations on how to organize a blood utilization improvement program.

Educating Physicians

"Education is the cornerstone of the improvement program," Hannon noted. "Physicians and everyone on staff need up-to-date education on the current risks, benefits, and alternatives to allogeneic transfusions. Use of evidence-based guidelines is another important element. Clinicians understand the importance of following these standards of practice.

"One of the most effective vehicles for orchestrating change is to organize a representative multi-disciplinary blood utilization committee within the hospital," he went on. "This group should be given the authority to exercise oversight over utilization of blood products. It can also be the catalyst for identifying best practices and introducing these into use.

"In conjunction with these activities, it is important to build active patient safety systems involving blood component therapy," Hannon commented. "One effective way to improve patient safety is to create cross-functional teams of laboratory and clinical staff to improve the quality, efficiency and safety of transfusion practices.

"Among other things, these cross-functional teams should review work flow and work processes to identify and address sources of waste and errors," he added. "All of these activities improve the stewardship of the community blood supply."

The multi-year success at St. Vincent Indianapolis Hospital at improving physician utilization of blood products, along with the substantial cost savings, provides other hospital laboratories with a useful road map on how to achieve similar improvements within their own organization. TDR

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Studies on Blood Use Reveal Positive and Negative Results

CURRENT STUDIES INDICATE THAT a significant portion of blood products are likely wasted, doing little good for the patients who receive them and, in some cases, creating harm.

A landmark study published in the *New England Journal of Medicine* (JAMA) in 1999, "Transfusion Requirements in Critical Care," compared liberal and restrictive approaches to transfusion in critically ill patients. The researchers randomly assigned 418 patients to a restrictive strategy, in which red cells were transfused if the hemoglobin concentration dropped below 7.0 g per deciliter, and 420 patients to a liberal strategy, in which transfusions were given when the hemoglobin concentration fell below 10.0 g per deciliter.

Outcomes for the two groups were not significantly different. But in one sub-group—those who were under 50 years of age and less acutely ill—less blood transfused was associated with significantly lower death rates at 30 days.

The restrictive strategy also decreased the average number of red-cell units transfused by 54%, saving a significant amount of blood as well as other valuable resources. The study concluded, "A restrictive strategy of red-cell transfusion is at least as effective as and possibly superior to a liberal transfusion strategy in critically ill patients, with the possible exception of patients with acute myocardial infarction and unstable angina."

INTELLIGENCE

LATE & LATENT

Items too late to print, too early to report

Kaiser Permanente Northern California says it now has all 21 hospitals and 160 clinics and medical offices up and running with a fully functioning electronic health record (EHR) system. This ends implementation of a decade-long effort that cost $4 billion. Kaiser claims that its HealthConnect EHR is currently the world's largest private sector EHR system. It connects more than 8.6 million patients with Kaiser's providers.

MORE ON: *Kaiser*

For pathologists and clinical lab administrators tracking how consumers accept and use EHRs, Kaiser released some interesting statistics. It says that more than three million beneficiaries actively use MyHealthManager, designed as a patient-friendly access to the EHR. MyHealthManage allows Internet access so that patients can view their health records, see prescription information, access laboratory test results, e-mail physicians, and view information about upcoming appointments.

BIO-REFERENCE GROWS 27% IN ITS SECOND QUARTER

Among all the national laboratory companies, the longest string of double-digit revenue growth quarters is held by **Bio-Reference Laboratories, Inc.** (BRLI), of Elmwood Park, New Jersey. Last week the company extended that record by one more quarter. BRLI released its earnings for its second quarter, ending April 30. Net revenue was a record $110.5 million, compared to $87.2 million in Q2-2009. It reported revenue per requisition of $80.00, which represented a 4% increase over the same quarter last year.

TRANSITIONS

• Valerie Palmieri was named President of **DiagnoCure Oncology Laboratories**, a U.S. subsidiary of **DiagnoCure, Inc.** which has its headquarters in Quebec City, Quebec. Palmieri formerly held executive positions with **Dianon Systems, Inc.**, and **Laboratory Corporation of America.**

• E. Blair Holladay, Ph.D., SCT(ASCP), will be the new Executive Vice President for the **American Society of Clinical Pathology** (ASCP). Blair will succeed John R. Ball, M.D., J.D., who is retiring at the end of the year after serving for eight years in the ASCP's highest staff leadership role. Holladay joined the ASCP in 2005 and currently handles multiple responsibilities.

DARK Daily
Clinical Laboratory and Pathology News/Trends

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That's all the insider intelligence for this report. Look for the next briefing on Monday, June 21, 2010.