BUSINESS/FINANCIAL DESK

WIDE U.S. INQUIRY INTO PURCHASING FOR HEALTH CARE

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The Justice Department has opened a broad criminal investigation of the medical-supply industry, apparently to determine whether hospitals and other medical care providers are fraudulently overcharging Medicare and other federal and state health programs for a wide array of goods -- from rubber gloves to drugs to X-ray machines.

More than a dozen medical-supply companies recently received federal subpoenas in what appears to be a wide-ranging investigation into the way suppliers market products to clinics, hospitals and nursing homes that serve Medicare and Medicaid patients, and whether those institutions properly account for the purchases.

Industry executives expect many hospitals to receive similar requests in coming weeks.

The central issue, according to current and former industry executives, is whether the industry's use of rebates, discounts, barter arrangements and refunds to hospitals and other medical centers means that Medicare and Medicaid are being charged higher prices for products than the hospitals are actually spending.

The investigation appears to be centered on the medical-supply industry's dealings with Novation, a company in Irving, Tex., that is an industry leader in negotiating the contracts that thousands of hospitals, clinics, nursing homes and other facilities use to buy drugs and other supplies.

About $20 billion a year in medical products and services are sold under contracts arranged by Novation, which is owned by about 2,200 of the hospitals and care centers that use its services. They include well-known medical centers like New York-Presbyterian Hospital, Yale-New Haven Health Services and Baylor Health Care System in Dallas.

Because Novation is the link between thousands of health facilities on one side, and hundreds of medical goods and services companies on the other, the scope of the federal investigation appears to be broad.

A Novation official confirmed this week that the company was recently served with a federal subpoena demanding that it produce documents.

"This matter is in the very early stages," Novation's senior vice president, Jody Hatcher, said in an e-mail reply to a reporter's questions. "Novation will fully cooperate with the U.S. attorney's office to provide the requested documents." Mr. Hatcher did not characterize the type of documents sought.

Mr. Hatcher also cautioned against drawing any inferences from the subpoena's references to various sections of the United States Code that deal with health care offenses.

"These subpoenas can be issued without any finding of misconduct," he said. "It would be misleading to state or imply that Novation, or any of its constituents or vendors, has violated any of the statutes you referenced."

Hospitals and clinics are financed with public money to a great degree, through programs like Medicare that reimburse many of the costs they incur in treating patients. If a hospital submits an erroneous cost report to Medicare, it can receive a larger reimbursement than it is due. If this is done knowingly, it can constitute Medicare fraud, which can carry fines and a 10-year prison sentence.

The federal investigation came to light after one medical products company, Becton, Dickinson, disclosed last week in its quarterly financial report that it had been served with a subpoena. Becton, Dickinson, the world's largest maker of medical needles and syringes, said in the report that it believed its transactions with Novation had "fully complied with the law," that it would cooperate and that it was not currently a target of the investigation.

Some of the other big companies to be served with subpoenas are the drug makers Merck, Bristol-Myers Squibb and Genentech; the G.E. Healthcare medical equipment unit of General Electric, and Cardinal Health, a big manufacturer and distributor of drugs and medical supplies.

Based on the federal codes cited in a copy of one of the subpoenas, investigators are seeking evidence of health care fraud, conspiracy to defraud the United States, theft or bribery involving programs receiving federal funds, obstruction of investigations and other possible violations. The subpoena was signed by Shannon Ross, criminal chief of the United States attorney's office in Dallas.

A spokeswoman for that office declined to discuss the subpoenas or to confirm that an investigation was in progress, citing longstanding policy. Most of the companies also declined to discuss the matter, other than to say that they would cooperate with investigators.

Novation's primary business is to pool the purchasing volume of about 2,200 hospitals, as well as thousands of nursing homes, clinics and physicians' practices, and to use their collective power to negotiate contracts with suppliers at a discount. In many cases, the contracts offer special rebates to hospitals that meet certain purchasing targets. Although Novation is not well known outside the industry, it wields formidable power because it can open, or impede, access to a vast institutional market for health products.

Novation's business practices, which were the subject of an investigation in 2002 by The New York Times, have drawn criticism from several parties , including the antitrust subcommittee of the Senate Judiciary Committee. The practices under scrutiny include questionable payments in the awarding of contracts and incomplete accounting of the rebates paid to hospitals and other medical centers.

The chairman and ranking member of the subcommittee, Mike DeWine, Republican of Ohio, and Herb Kohl, a Wisconsin Democrat, have been monitoring Novation and other companies involved in the group purchasing of health products. In hearings, they have expressed concerns about possible abuses and have publicly called on companies in the industry to adopt heightened ethics policies or risk tighter regulation. The subcommittee is expected to hold another hearing on the issue next month.

Novation has also been attacked by other companies, in past testimony to the subcommittee and through civil suits brought by small medical suppliers that accused it of freezing them out of a big share of the market for medical products. But until now, Novation was not known to have been named in a criminal investigation.

In July, Becton, Dickinson, paid $100 million to settle a lawsuit in which a smaller needle manufacturer accused it of working with Novation and other purchasing companies to freeze competitors out of the institutional market. Becton, Dickinson denied any improper behavior in that case, saying it settled to avoid protracted and costly litigation.

A spokesman for Premier Inc. of San Diego, the nation's second-largest hospital purchasing company, said that Premier had not received a subpoena.

Novation was created in 1998 as a joint venture of two networks of nonprofit hospitals, VHA Inc. of Irving, Tex., and University HealthSystem Consortium of Oak Brook, Ill. The two networks are cooperatives that also provide services like consulting and data analysis for their members.

VHA, the larger of the two networks, holds the larger stake in Novation. It is composed of about 1,400 nonprofit hospitals -- about one-fourth of the nation's total -- and 800 other health facilities. Many of its members are small and relatively obscure, but some are large and well known. Besides New York-Presbyterian, Yale-New Haven and Baylor, they include Massachusetts General Hospital in Boston and the University of Pennsylvania Health System in Philadelphia. A spokesman for VHA referred questions about the investigation to Novation.

University HealthSystem Consortium is much smaller than VHA but consists of many prestigious teaching and research hospitals, including Johns Hopkins Hospital, N.Y.U. Medical Center, Mount Sinai Medical Center and various facilities of the State University of New York. Its hospitals are considered an extremely attractive market by suppliers, because they tend to perform unusual procedures and buy more high-end devices.

An official of University HealthSystem Consortium said that the organization had not been subpoenaed but that the consortium "would assist Novation in responding to the subpoena that they have received."

People in the medical-supply business who were aware of the subpoenas said the investigators wanted records of payments made by suppliers to Novation and to the hospitals and other facilities that use its contracts.

"It's about the money, and you've got to be able to track where the money goes," said a former Novation executive, who would discuss Novation's operations only anonymously because he was "concerned about being completely blackballed" in the industry.

The executive said he had been contacted by an investigator from the Department of Health and Human Services' Office of Inspector General, who asked for the same type of information the Justice Department is seeking: the nature of the payments that suppliers make to Novation, how Novation picks which companies will be awarded contracts and what Novation does with the payments it receives from suppliers.

In most cases, suppliers are not permitted to make gifts or payments to purchasing agents for health facilities that receive Medicare money, because of the risk that some might offer kickbacks in their efforts to win business. But Novation operates within a "safe harbor" of the anti-kickback law, created specially for hospital purchasing groups.

The provision allows Novation to accept payments from suppliers with no legal consequence, as long as those payments do not exceed the safe-harbor limit, which is 3 percent of the suppliers' sales through Novation's contracts.

Over the years, these payments have become customary in the business. They are called administrative fees, because they are supposed to cover the cost of administering the contracts.

But industry records show that some companies have made other types of payments to Novation as well, and the total payments have sometimes exceeded the safe-harbor limit, sometimes surpassing 10 percent. Companies also contribute seed money to various initiatives and programs conducted by Novation's parent, VHA, and to a related foundation, the VHA Health Foundation, which finances health-delivery projects undertaken in VHA hospitals.

Because businesses set up as cooperatives are barred from retaining capital, Novation and its two parent companies are required each year to distribute all of these payments to their member hospitals, after subtracting operating expenses. Those yearly distributions, as well as the rebates to hospitals that meet their purchasing contract targets and certain in-kind contributions, effectively lower the hospitals' purchasing costs.

But because Novation is not publicly traded, there is no public accounting of these distributions. Some of the distributions are not made in cash, meanwhile, but in coupons that hospitals can use to purchase consulting services from VHA.

Hospital officials say privately that the complexity of these flows of funds makes it next to impossible to state the true costs of the drugs and other supplies they purchase each year, when they report their expenses to Medicare.

The former Novation executive said he believed that the federal investigators might see similarities in those arrangements to payments that drug companies have made to doctors who prescribed their brands -- payments that have led to multibillion-dollar settlements by some pharmaceutical companies.

"Pharmaceuticals are referred to in the press because the average reader can associate with them more," the former executive said. "Consumers don't buy operating-room tables or X-ray machines, or that kind of stuff, but you've got the same sort of thing going on. And it's huge, huge money."

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