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MEDICINE'S MIDDLEMEN

Hospital Group's Link to Company Is Criticized

By MARY WILLIAMS WALSH

t a time when many nonprofit hospitals are struggling, a large group owned by those hospitals is spending tens of millions of dollars to shore up its investment in a for-profit electronic commerce company in which some of the group's officials own stock.

Told of this arrangement, some hospital executives criticized it as a conflict of interest.

Last year, the hospital group, Novation, and the hospitals that own it backed the electronic commerce company, Neoforma, with about $70 million in subsidies, stock purchases and loans. Neoforma, a Web site where Novation hospitals and others can buy supplies, has never turned a profit and has reported losses of $500 million since it was founded in 1996.

Novation and its affiliates own 61 percent of Neoforma, and 10 officials who play a role in overseeing Novation also own or have owned stock in the company, according to Securities and Exchange Commission filings. Their investments have ranged from several thousand dollars to more than $150,000. Last year, Novation supplied 88 percent of Neoforma's revenues.

"That presents a problem to me," said E. Chandler Bramlett, chief executive of the Infirmary Health System, a large network of nonprofit hospitals in Alabama that buys through Novation, after being told of the investments. "If someone has a financial stake in an organization, and they have the ability to determine how much funds will go to this organization, that has the potential to cloud their objectivity."

Novation is a joint venture of two large networks of hospitals, VHA Inc. and University HealthSystem Consortium, whose members include the teaching hospitals at universities like Georgetown and Yale. Its mission is to use the collective market power of its hospitals to find the best medical products at the lowest prices.

Novation and other buying groups like it are supposed to serve as unbiased middlemen. But some current and former officials of Novation's nonprofit member hospitals say the group is compromised by conflicts of interest when the group and its officials own stock in a for-profit company with which it does business.

Neoforma went public in January 2000, shortly before Novation announced a 10-year contract with the company. The stock price quadrupled on the first day of trading and soared further in the weeks after that. The stock has since collapsed and is trading at a tiny fraction of its record high.

Mr. Bramlett questioned whether Novation should continue to subsidize Neoforma. "That's our money," he said. "If it's not recouped, and we're putting good money after bad, then I have a major problem with that."

Despite the subsidies, only 486 hospitals of Novation's 2,500 hospitals use the Neoforma Web site to buy supplies, though officials say that number is growing. Some hospitals say they are not convinced that it can save them money.

Congress plans to hold hearings on Tuesday to investigate the business practices of groups like Novation that negotiate contracts for medical supplies on behalf of hospitals.

Curt Nonomaque, a director of Neoforma and chief financial officer of VHA, said Novation turned to Neoforma at the urging of its member hospitals, which had complained that they were wasting time and money ordering supplies by fax and other outdated methods. Mr. Nonomaque cited a study his group commissioned that found electronic commerce could save manufacturers and hospitals millions of dollars.

But some hospital executives say Novation officials have shown scant interest in their opinion of Neoforma.

"There was very little shareholder input," said Dennis A. Hall, chief executive of Baptist Health System, a chain of hospitals in Birmingham, Ala., that buys through Novation.

Mr. Hall called the Neoforma investment "very risky," and said Novation's hospitals "need to have a lot more information." Even so, he said, his hospital has little choice but to start using Neoforma.

"Put yourself in our shoes," he said. "Our money was invested in this company. What choice do we have? The worst thing that could happen to us would be if Neoforma failed, now that the investment has been made."

Mr. Hall said Baptist Health would start ordering supplies through Neoforma later this year.

The idea of buying medical supplies through a Web site is in theory very attractive. Neoforma was supposed to allow hospitals to order more easily and accurately, track deliveries and better manage their inventories. Novation saw the potential of such a service — and the competitive threat. The two hospital networks that own and use Novation eventually acquired a majority of the company's stock.

But there was a problem. In the world of medical supplies, the purchasing groups are financed not by the hospitals but by the medical supply companies themselves. Neoforma wanted these companies to finance its operations by paying fees for each product sold through its Web site. But suppliers, who were already paying fees to Novation on products sold outside the Web site, balked at the additional money.

Nor were medical supply companies interested in signing up with any Web site that might post their prices next to competitors' prices, allowing instant comparison by hospitals, said Lawton R. Burns, director of the Center for Health Management and Economics at the Wharton School of the University of Pennsylvania.

Supplier reluctance to sign up — and outright refusal to pay fees — left Neoforma without a revenue source that had been crucial. So Novation decided to pay Neoforma the fees itself, using the hospitals' money instead. Last year alone, that amounted to about $24.6 million.

"The question is: How long can Novation support Neoforma?" said Michael Bohon, director of materials management for TMC Healthcare, the corporate parent of the Tucson Medical Center. "Who's paying for it? We are."

Officials at a smaller buying group, Amerinet, said they concluded that the Neoforma model would not work for hospitals.

Speaking of the additional fees charged to suppliers for products sold on the Web site, Robert P. Bowen, Amerinet's president, said "We just felt that this additional cost was going to add costs to the supply chain, and that shouldn't be what this is all about." He also noted noting that all were expecting suppliers to pay the fees.

He said his buying group's mission was not to invest in companies but to "write contracts that benefit our members."

As for personal investments in companies with which one does business, Mr. Bowen says his group does not allow that.

But Mr. Nonomaque, who sits on Novation's board, faced no such prohibition when it came to investing in Neoforma. At one point in 2001 he owned about $150,000 in Neoforma stock, according to S.E.C. records. Mr. Nonomaque sold that stock in November 2001.

VHA's chief executive, C. Thomas Smith, who also sits on Novation's board, owns 3,500 shares of Neoforma's stock, worth about $66,000, records show.

"I believe in the future of e-commerce," Mr. Smith said, explaining why he had invested in Neoforma. "I've made the choice that this is something I would like to put my personal resources in."

Mr. Nonomaque said that he had originally bought Neoforma's stock because he wanted to send a bullish message about the company. "One analyst in particular had cited my investment in Neoforma as a real positive sign of support for that company," Mr. Nonomaque said.

But some hospital officials, when told of these investments, say they are troubled that their buying group's officials are investing in a company that does business with Novation.

"Of course it sends that message to Wall Street, but what message does it send to VHA member hospitals?" asked Mr. Hall of Baptist Health System. "It sends a signal to Wall Street that they have a conflict of interest. These people are going to do whatever they can to make that company succeed."

He added: "My board, at Baptist Health System, would be very concerned if they found out that I was a stockholder in a company that we were thinking of awarding a contract to."

Despite Novation's efforts to promote the company, most member hospitals have not signed up to use Neoforma, in part because they believe that the cost of switching to Neoforma would outweigh any savings. One problem they cite is that not enough manufacturers and distributors have posted their products on Neoforma's Web site.

Faced with a refusal by many companies to do business with Neoforma, Novation last fall stepped up the pressure. If a manufacturer wanted to sell products to Novation hospitals, it would have to sign up with Neoforma.

Novation's tactic persuaded some manufacturers to at least sign up for Neoforma. As of March 31, Neoforma said it had reached agreements with 214 companies.