



2006 HOSPITAL OUTSOURCING TRENDS IN CLINICAL SERVICES COMMENTARY

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Although hospitals have long outsourced certain support services such as food and laundry services, the outsourcing of patient care services is a relatively recent phenomenon except for certain specialized clinical services such as rehabilitation services and emergency department staffing. As attorneys who advise healthcare providers, Waller Lansden commissioned the 2006 Hospital Outsourcing Trends in Clinical Services Survey (the Survey) not only to gauge the prevalence of hospital outsourcing but to better understand

the types of patient care services being outsourced, how decisions are being made to outsource patient care services, and the models that hospitals are using to outsource patient care services. We believe this information can be very helpful to hospital executives who are considering their options with respect to outsourcing patient care services. Further, we believe the Survey offers benchmarks from which we can gauge future developments in the outsourcing of patient care services.

The Prevalence of Hospital Outsourcing of Patient Care Services

Seventy-eight percent of the respondents to the Survey indicated that they are currently outsourcing some patient care services. Nearly half of Survey respondents (45 percent) currently outsource one or two patient care services. However, a significant percentage (21 percent) of the respondents currently outsource five or more patient care services. Further, the Survey did not indicate much of a difference between the outsourcing of patient care services

between for-profit hospitals and health systems (84 percent currently outsource patient care services) and tax-exempt hospitals and health systems (77 percent currently outsource patient care services). Over one-half of the respondents obtain one to nine percent of their revenue from outsourced patient services and another 11 percent get 10 to 19 percent.

Although one might have expected smaller hospitals to outsource more patient care

services due to the difficulty of establishing specialized patient care services in a cost-efficient manner in a smaller setting, we were surprised to find that among the respondents to the Survey, larger hospitals (200 beds or more) were more likely to outsource patient care services than small hospitals (less than 50 beds). Specifically, 68 percent of small hospitals indicated that they currently outsource patient care services compared to 86 percent of larger hospitals.

Types of Patient Care Services Being Outsourced

According to the Survey, the top ten patient care services currently being outsourced are:

Dialysis	31%
Sleep Disorders	24%
Diagnostic Imaging	23%
Laboratory Services	20%
Physical Therapy	18%
Hospitalists	17%
Specialty Equipment	17%
Rehabilitation Services	14%
Hospice Care	13%
Wound Care	13%

Further, when asked what patient care services they were looking to outsource in the next 12 months, the most popular responses were: sleep services, wound care, hospitalists and physical therapy.

Several observations can be

made with respect to top ten outsourced services identified above. First, the categories of patient care services being outsourced either require specialized knowledge or specialized equipment to deliver the services in a cost-effective manner. For example, a hospital looking to develop a hospitalist program may elect to outsource the service because it lacks the program knowledge and experience necessary to launch the service in a cost-effective manner. Such specialized knowledge includes understanding staffing ratios, billing acumen, and marketing the service to physicians and third-party payors. Similarly, a hospital may outsource to defray the capital costs of developing a new service when it is unclear

that demand will be sufficient to covers such costs. For example, a hospital seeking to develop a wound care center may decide to outsource the center because it does not want to make the capital commitment to build out the center, including the purchase of hyperbaric chambers.

Second, the listing suggests that patient care outsourcing decisions continue to be driven by reimbursement considerations. For instance, it is not surprising that dialysis services were the number one outsourced patient care services. Despite the fact that Medicare pays hospital-based ESRD facilities slightly more than free-standing ESRD facilities, hospitals typically lose money on the provision of dialysis services to

inpatients. Therefore, many hospitals have chosen to cease providing dialysis services completely. Instead, such hospitals will contract with a freestanding center to provide both inpatient and outpatient dialysis services to the hospital's patients.

Third, several of the top ten outsourced patient care services are fairly new patient service lines that hospitals may be initiating for the first time or joint venturing with members of its medical staff. For example, we have observed an increase in sleep laboratory ventures in our practice. Hospitals often evaluate these ventures with full awareness that if they do not partner with medical staff members to develop such services, members of their medical staff may develop competing facilities. On the other hand, wound care services, another comparatively new patient service line for most hospitals, will typically be furnished by a third party management company since few physicians have significant wound care experience.

Fourth, several of the top ten outsourced patient care services are rather well-established patient care services for which the hospital industry has significant experience utilizing third party delivery. For example, many hospitals have relied upon outside vendors to deliver hospice services, rehabilitation services and clinical laboratory services. While some hospitals continue to utilize outside vendors to furnish such services, others have decided that they can move the service in-house without a loss of either efficacy or efficiency.

Fifth, the inclusion of certain patient care services in the Survey's top ten outsourced patient care services is probably more a factor of overall activity in that segment of the healthcare industry rather than any other characteristic of the service. For example, the number of new diagnostic imaging providers has increased significantly within the past several years. This activity has led more hospitals to evaluate service delivery alternatives for

imaging services in both inpatient and outpatient settings. Similarly, as already mentioned, sleep laboratory services have seen similar growth in recent years.

Sixth, and finally, the inclusion of several patient care services on the Survey's list of top ten outsourced patient care services most likely results from a favorable treatment of the service under the Federal physician self-referral prohibition, commonly referred to as the Stark law. Although the law prohibits many financial relationships between hospitals and physicians in a position to make referrals to the hospital, the law treats favorably patient care services such as imaging center joint ventures with radiologists, dialysis center joint ventures, sleep laboratory joint ventures, cancer center joint ventures with radiation oncologists (11th most frequently outsourced according to our Survey) and outpatient surgery center joint ventures (13th most frequently outsourced according to our Survey).

How Are Decisions Being Made?

The Survey asked respondents to indicate their top two reasons for outsourcing a particular patient care service. More than half of the respondents indicated that vendor expertise is their primary reason for choosing to outsource a particular patient care service. However, as we observed above, financial considerations weigh heavily in a hospital's decision to choose to outsource. Specifically, respondents indicat-

ed that the following financial concerns influenced their decision to outsource a patient care service: (1) cost savings (23 percent of Survey respondents); (2) revenue enhancement (18 percent of Survey respondents) and (3) access to capital (8 percent of the Survey respondents). As hospitals continue to reinvent themselves in response to changes in both payment systems and patient demands for services, the outsourcing of a

new patient care service is often a chance to develop a new revenue stream while reducing the hospital's overall financial commitment and exposure to the new service line.

We were somewhat surprised that requests by physicians for outsourcing a patient care service were only indicated by 17 percent of the Survey respondents. Anecdotally, we often hear that a hospital's decision to move into a particular service

line or to restructure an existing patient care service line is driven by the demands of physicians. This may be either an offensive or defensive move to partner with physicians before the hospital is faced with the possibility of competing with physicians. Or, it may be simply to distinguish the hospital's existing service lines to attract a

given specialist.

Ten percent of the respondents indicated that they had stopped some outsourcing of patient services in the last 24 months. Only five services were mentioned more than once (each was mentioned twice): sleep services, physical therapy, radiology, behavioral health and food services. Of the 26 hospitals that indi-

cated that they had stopped outsourcing some services, the most frequently cited reasons were cost (54 percent) and vendor quality (31 percent). Given that vendor expertise and cost savings were cited as primary reasons for outsourcing, it is not surprising that the outsourcing arrangement would be terminated if these goals were not attained.

How Are Outsourced Patient Care Services Being Structured?

For the purposes of our Survey, three basic structures were identified for outsourcing patient care services:

(a) Structures whereby the hospital joint ventures the service and the profits are split among the joint venture partners;

(b) Contractual arrangements whereby the vendor of the service retains residual profits associated with the service; and

(c) Agreements with outside vendors where the profits are retained by the hospital or health system.

A joint venture between a hospital and its surgeons to provide outpatient surgery services is an example of a joint venture described in (a) since the revenue would be collected by the joint venture entity and the profits would be split between the owners of the joint venture. A contract between a hospital and a vendor of laboratory services is an example of (b). Finally, a joint venture between a hospital and its neurologists to create a new legal entity to purchase a

gamma knife that will be leased to the hospital so that the hospital can provide gamma knife services to its patients would be treated simply as an agreement with an outside vendor is an example of (c) because the gamma knife services would be billed by the hospital and all

profits from the service would be retained by the hospital.

The following chart stratifies the structure of these arrangements by the type of patient care service being outsourced (the most common structure is indicated in bold per patient care service):

	Joint Venture (profits to JV Entity)	Contractual Arrangement (profits retained by vendor)	Outside Vendor Agreement (profits retained by hospital)
Dialysis Services	11%	50%	39%
Sleep Disorders	28%	15%	56%
Diagnostic Imaging	26%	37%	37%
Laboratory Services	19%	42%	40%
Physical Therapy	21%	23%	56%
Specialty Equipment	10%	29%	60%
Hospitalists	6%	67%	27%
Rehabilitation Services	13%	21%	66%
Hospice Care	26%	51%	23%
Wound Care	23%	29%	49%
Cancer Center	42%	27%	30%
Behavioral Health	11%	37%	52%
Outpatient Surgery	81%	15%	4%
LTAC	32%	42%	26%
Bariatric Surgery	58%	25%	17%
Geriatrics	50%	33%	17%
Other	6%	31%	63%

This stratified data shows that true joint venture opportunities are limited. In our experience, the primary limitations to such joint ventures are the Stark law and reimbursement. That is, as discussed above, certain services are capable of being joint ventured between a hospital and referring physicians without violating the Stark law. We assume that this explains the prevalence of the joint venture structure in outpatient surgery, bariatric surgery and cancer centers. We were surprised that more sleep lab arrangements were not structured as joint ventures given similar favorable treatment under the Stark law. Likewise, many bariatric surgery joint ventures were originally structured to carve out Medicare and Medicaid patients. Except for diagnostic imaging, those patient care services that are primarily structured as contractual arrange-

ments are fairly well established patient service lines. In many instances, we anticipate that many hospitals providing such patient care services pursuant to contractual arrangements once provided such services directly and found that the service requires specialized knowledge with modest operational margins. Further, in some cases, the service line was heavily targeted by the government in the past (e.g., laboratory services). These factors would explain why hospitals made the decision to continue to their patients but let a specialized service vendor "own" the service.

Although the last category, contractual agreements, represents the least integrated of the structural models, it probably represents a larger variation of models than the other structures. Outsource rela-

tionships within this structure can range from simple management agreements to purchased service arrangements, from a virtual hospital within a hospital to an under arrangement relationship between the hospital and the service vendor. Given the fact that arrangements adopting this structure clearly remain the hospital's service, many arrangements in this structure are transitional in nature. The hospital may desire to start a new service line and want outside expertise for a limited period of time (e.g., sleep lab, rehabilitation services and behavioral services) until it internally develops such skill set. Or, the contractual agreement may simply be a stepping-stone to a more integrated relationship between the hospital and members of its medical staff (e.g., outpatient imaging and sleep lab services).

What Outsourcing Changes Are Planned?

Twelve percent of the respondents intend to outsource additional patient services in the next 12 months. The services mentioned most frequently were sleep services, wound care, hospitalist and physical therapy, which is generally consistent with our current Survey. Most of the respondents (65 percent)

said they expect to continue outsourcing at the same level for the next two to three years, while eighteen percent expect their level of outsourcing to increase, twelve percent expect it to decrease and five percent do not know. The reasons cited for doing so were request by physicians (45 percent), expertise of

vendor (42 percent), add a new service line (42 percent) and revenue enhancement (35 percent). As noted above, we expected that request by physicians would have been cited more frequently as a reason for current outsourcing than was the case. We observed that it is the most cited reason for planned outsourcing.

Additional Information

If you have additional questions or comments regarding the Survey, please contact any of the following attorneys, who served as the primary authors of this commentary, or any other member of Waller Lansden's Healthcare practice.

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