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2016 Antitrust Case Law And FTC Action Highlight Agency's Approach to Hospital Mergers

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In 2016, the Federal Trade Commission prevailed in litigation before the Third and Seventh Circuit Courts of Appeal related to two high-profile hospital mergers. In both cases, the courts of appeal overturned the federal district courts' decisions denying preliminary injunctions to stop the mergers. In another matter, the FTC dropped its complaint after the State of West Virginia enacted a statute that immunized certain hospital mergers from antitrust laws, and its hospital authority approved the hospital merger under the statute.

The decisions by the Third and Seventh Circuit Courts of Appeal and the FTC's abandonment of the FTC's challenge of the West Virginia merger provide guidance for healthcare providers about how courts and the enforcement agencies analyze mergers between hospitals under the antitrust laws. Key takeaways include:

1. When evaluating the relevant geographic market, courts and enforcement agencies will likely view specialized hospitals and academic institutions differently from local general acute care hospitals. The fact that some patients travel long distances for specialty care may not rebut the agencies' argument that "general acute care services are inherently local."

2. The decisions from the Third and Seventh Circuits confirm that the FTC continues to use the hypothetical monopolist test in evaluating the relevant market for healthcare transactions.

3. The agencies' and the courts' approaches to mergers differ from jurisdiction to jurisdiction, and parties to healthcare mergers and acquisitions should consult with antitrust counsel who can examine their transactions.

4. In addition to considering the impact of hospital mergers on consumers, hospitals looking to merge or enter into similar transactions need to consider the impact on insurers. If insurers oppose a merger and testify that they are unable to offer a network without at least one of the merging parties, the merging parties may have an uphill battle in getting the green light from the regulators and the courts.

5. Private arrangements between hospitals and insurers to curb price increases after a merger will typically not turn an anticompetitive merger or acquisition into a procompetitive one, but agreements between hospitals and state officials may be relevant in some jurisdictions, like West Virginia.

6. A merger's efficiencies need to be carefully considered by counsel and the parties. To help defend a merger, efficiencies need to be merger-specific, i.e., not available to the parties individually absent the merger, and parties to a merger may be required to show that cost savings or other benefits will be passed on to payors and patients.

7. Hospitals should evaluate whether their state statutes immunize their transactions, and consider the potential enforceability of such statutes if challenged by the FTC.

8. Merging parties should consult antitrust counsel with experience in healthcare transactions to assess antitrust risk and, if necessary, to prepare a defense to a regulatory challenge.

The two recent decisions by the Third and Seventh Circuit Courts of Appeal and the FTC's action in another hospital merger are summarized as follows:

I. FTC v. Advocate Health Care Network, et al.

In December 2015, the FTC filed a complaint in the Northern District of Illinois seeking to prevent a proposed merger between North Shore University Health System and Advocate Health Care Network. *FTC v. Advocate Health Care Network et al.,* 15 C 11473 (N.D. Ill. 2015). The district court used the "hypothetical monopolist test"[1] and found that the FTC had failed to establish the relevant geographic market and denied the FTC's request to enjoin the merger. The FTC appealed the district court's decision to the Seventh Circuit Court of Appeals. On October 31, 2016, the Seventh Circuit reversed the district court's refusal to block the merger and remanded the case for further proceedings. *FTC v. Advocate Health Care Network et al.,* 16-2492 (7th Cir. Oct. 31, 2016).

The Seventh Circuit said the district court's ruling was wrong in several ways. First, the district court misapplied the hypothetical monopolist test. The court of appeals explained that "if a candidate market is too narrow, the test will show as much, and further iterations will broaden the market until it is big enough." *Id*. at 26. But the district court incorrectly considered those iterations to be circular reasoning. It criticized the FTC expert's proposed market for "'assum[ing] the answer' to the market definition question." *Id*. at 27.

1 The "hypothetical monopolist" test is used by the FTC to determine the relevant product and geographic markets. The test asks whether a hypothetical monopolist could profitably impose a small but significant non-transitory increase in price ("SSNIP") in the product and geographic market as defined. If it could do so, then the market is properly defined. If, however, a hypothetical monopolist could not profitably impose a SSNIP, then the proposed market definition is too narrow (i.e., it does not include all competing firms), and the market must be expanded until it is properly defined.

The court of appeals rejected the district court's analysis: "the candidate market offers a hypothetical answer to [the market definition] question; the hypothetical monopolist analysis then tests the hypothesis and adjusts the market definition if the results require it." *Id*. This was not circular reasoning, but merely a correct application of the hypothetical monopolist test.

Second, the court of appeals said the district court misunderstood the realities of the healthcare market. The FTC expert correctly excluded academic medical centers from his analysis because the demand for those hospitals differs from demand for general acute care hospitals like the merging hospitals, and the district court incorrectly rejected the FTC expert's conclusion. Further, the evidence demonstrated that most patients in the region prefer to visit local hospitals. The Seventh Circuit also explained that the most relevant buyers of acute care hospital services are generally payors, not patients. This was particularly important because the evidence demonstrated that any marketable healthcare plan needed to include either Advocate Hospital Care Network or North Shore Hospital. More distant academic medical centers were not a substitute for local general acute care hospitals from the payors' and employers' point of view.

The FTC successfully argued that the district court's acceptance of the hospitals' proposed geographic market was incorrect. The appellate court's ruling does not mean the proposed merger has been found to be anticompetitive yet. The district court is currently evaluating the FTC's request for a preliminary injunction that would prevent the merger, and this time it will apply the geographic market required by the Seventh Circuit. The district court has stayed the merger pending its ruling on the FTC's request for the preliminary injunction.

II. FTC v. Penn State Hershey Medical Center et al.

Pennsylvania hospitals Penn State Hershey Medical Center and PinnacleHealth System proposed to merge in June 2014. On December 7, 2015, the FTC sought a preliminary injunction to prevent the merger, which the district court denied. The district court found that the FTC did not properly define the relevant geographic market, and the FTC appealed the district court's order.

On September 27, 2016, the Third Circuit reversed the district court's decision. *FTC v. Penn State Hershey Med. Ctr. et al.,* No. 16-2365 (3d Cir. Sept. 27, 2016). It first found that the market proposed by the FTC, not the one adopted by the district court, was correct. The appellate court then found that the proposed merger was anticompetitive and rejected the district court's analysis of the "equities" in favor of the proposed merger.

A. The Geographic Market

The Third Circuit overturned the district court's decision about the geographic market for three reasons. First, the district court improperly evaluated the number of patients from outside the proposed geographic market who sought services at the merging hospitals. The Third Circuit explained that the district court's decision was incorrect due to the "silent majority fallacy," under which the district court incorrectly assumed that the fact that some patients travel long distances to a hospital shows that the hospital does not have market power with respect to non-traveling local patients. As in the *Advocate Health* case, the Third Circuit found that "high number of patients who do not travel long distances for healthcare supports the Government's contention that [general acute care] services are inherently local."

Also, the district court incorrectly focused solely on patients, not insurers, as the relevant buyers. According to the Third Circuit, testimony from insurers had established that "payors would not be able to market a healthcare plan to Harrisburg-area residents that did not include Harrisburg-area hospitals." While patients were relevant to the analysis, the court explained that insurers were the proper focus of the inquiry.

Last, the district court was wrong to consider a private agreement between the hospitals and the insurers in Central Pennsylvania, which tried to ensure that post-merger rates would not increase for five years with one insurer and ten years with the other. The Third Circuit cautioned that these private contracts are not to be considered when applying the hypothetical monopolist test to define the relevant market. If the court were to consider such agreements, then any merging entity could enter into similar arrangements, regardless of whether they are enforceable, to improperly avoid antitrust enforcement. The Third Circuit explained that these private pricing arrangements may be an effective tool for the FTC and merging parties to use in regulatory actions, but that they had no place in the court's antitrust analysis.

After finding that the district court's analysis was incorrect, the Third Circuit then said that the FTC adequately defined the relevant geographic market because the increase in the hospitals' bargaining leverage resulting from the merger would allow the merged entity to profitably impose a SSNIP on payors of hospital's services.

B. The Third Circuit Found the Merger to be Presumptively Anticompetitive

The Third Circuit then determined whether the proposed merger was presumptively anticompetitive by applying the Herfindahl-Hirschman Index ("HHI"). This test is often used by courts and the FTC to determine the effect of a merger on market concentration, which indicates whether the merger will restrict competition in the market. Increases in concentration above certain levels are thought to make the proposed merger presumptively anticompetitive.

Applying the HHI test, the district court explained that the government put forth undisputed evidence that the post-merger HHI would have been 5,984, more than twice of that of a highly concentrated market (a market with an HHI of over 2,500 is considered to be highly concentrated). Further, the merger would have given the combined entity a 76% share of the market, which is alone sufficient to create a presumption of illegality under some antitrust case law. Together, the market concentration and the hospitals' combined share of the market demonstrated that the proposed merger was presumptively anticompetitive.

C. Rebutting the Presumption of Anticompetitiveness

In response, the hospitals argued that the merger would create two efficiencies: (1) the merger would produce procompetitive effects, including relieving Hershey's capacity constraints and allowing Hershey to avoid construction of an expensive bed tower; and (2) the hospitals claimed that the merger would enhance their efforts to engage in risk-based contracting. The hospitals also claimed that the merger would not have anticompetitive effects because of repositioning by other hospitals in the area. The court of appeals rejected the hospitals' arguments and found the merger to be anticompetitive.

Efficiencies defense: The Third Circuit concluded that the hospitals' claimed efficiencies were not sufficient to rebut the presumption of anticompetitiveness.[2] The district court had found that the merger would alleviate Hershey's capacity

2 Significantly, the Third Circuit said that neither the U.S. Supreme Court nor the Third Circuit has ever formally adopted the efficiencies of the merger as a defense to violations of the antitrust laws. The Third Circuit rejected the hospitals' efficiency arguments, without first deciding whether the "efficiencies defense" is valid as a matter of law.

constraints and that it would allow it to avoid constructing a new bed tower that would have cost nearly $277 million, but the Third Circuit disagreed that this efficiency was sufficient to overcome the presumption. The hospitals also argued that the merger would have enhanced their efforts to engage in risk-based contracting, an alternative payment model to the traditional fee-for-service model. The Third Circuit disagreed with the hospitals' argument, explaining that they did not show that the benefit would ultimately be passed on to consumers. The Third Circuit also explained that the supposed benefit was not merger-specific because both hospitals could engage in risk-based contracting without the merger.

Anticompetitive effects: Additionally, the hospitals claimed that repositioning—the response by competitors to offer substitutes for the services offered by the merging hospitals—would be sufficient to overcome the presumption of anticompetitiveness. The district court had agreed, finding that other hospitals in the area had acquired and affiliated with other competitors. However, the Third Circuit rejected this argument, explaining that the repositioning by the hospitals would not constrain a post-merger price increase because payors testified that "there would be no network" without the merged hospitals.

Weighing the equities: Finally, the Third Circuit "weighed the equities" to determine whether delaying the merger would harm the public more than allowing it to move forward at the preliminary injunction stage. Unlike the district court, the Third Circuit focused on whether the injunction, not the ultimate result of the merger, would be in the public interest. The court found that the public's interest in effective antitrust enforcement exceeded the harm that would result from a delay in the proposed merger. The Third Circuit also explained that if the preliminary injunction were denied, and the FTC later showed that it was right about the merger's anticompetitive effects, it would be "extraordinarily difficult to unscramble the egg."

As a result of the Third Circuit's decision, the Pennsylvania hospitals announced their decision to abandon the merger.

III. Cabell Huntington Hospital and St. Mary's Medical Center Merger in West Virginia

In November 2015, the FTC filed an administrative complaint, alleging that the proposed merger between Cabell Huntington Hospital and St. Mary's Medical Center in West Virginia violated antitrust laws. The FTC contended that the two hospitals, which were the only two hospitals in Huntington, West Virginia, were each other's closest competitors for general acute care inpatient hospital and outpatient surgical services. The merger would have resulted in a dominant firm with more than 75% market share. The FTC also claimed that the supposed efficiencies of the merger were speculative, not merger specific, and were outweighed by the anticompetitive effects of higher prices and lower quality of care.

In March 2016, the West Virginia legislature passed a law relating to "cooperative agreements" between hospitals in that state, and the West Virginia Health Care Authority approved one such cooperative agreement between the hospitals. The West Virginia Attorney General concurred. This legislation is specifically designed to immunize certain "cooperative agreements" from state and federal antitrust laws.

A. The West Virginia "Cooperative Agreement" Statute

W. Va. Stat. § 16-29B-28 defines "cooperative agreements" as agreements "between a qualified hospital which is a member of an academic medical center and one or more hospitals or other health care providers." The agreement "shall provide for the sharing, allocation, consolidation by merger or other combination of assets, or referral of patients, personnel,

instructional programs, support services and facilities or medical, diagnostic, or laboratory facilities or procedures or other services traditionally offered by hospitals or other health care providers." W. Va. Stat. § 16-29B-28(a)(2).

The stated purpose of the statute is to permit "cooperative agreements" that would otherwise violate the antitrust laws to proceed: "The Legislature encourages cooperative agreements if the likely benefits of such agreements outweigh any disadvantages attributable to a reduction in competition. When a cooperative agreement, and the planning and negotiations of cooperative agreements, might be anticompetitive within the meaning and intent of state and federal antitrust laws the Legislature believes it is in the state's best interest to supplant such laws with regulatory approval and oversight by the Health Care Authority as set out in this article." W. Va. Stat. § 16-29B-28(c). The law requires the Health Care Authority to weigh benefits of a merger with its potential anticompetitive effects. W. Va. Stat. § 16-29B-28(f)(4)-(5).

Under the West Virginia statute, a hospital party to a cooperative agreement and state officials or agencies may enter into agreements imposing certain restrictions on rate increases. These agreements are enforceable and "may be considered by the authority in determining whether to approve or deny the application" for the cooperative agreement. W. Va. Stat. § 16-29B-28(i)(1)(A).

B. Impact of West Virginia Law on Federal Antitrust Enforcement

In a statement issued after the West Virginia Legislature passed the "cooperative agreement" law, the FTC wrote that the merger between Cabell Huntington Hospital and St. Mary's Medical Center, the only two hospitals in Huntington, West Virginia, is "likely to increase prices and degrade quality of care." Statement of the FTC, *in re Cabell Huntington Hospital, Inc.,* Dkt. No. 9366, at 1 (July 6, 2016), available at https://www.ftc.gov/system/files/documents/public_statements/969783/160706cabellcommstmt.pdf. The FTC nonetheless dismissed the administrative complaint without prejudice in light of the passage of the "cooperative agreement" law and the West Virginia Health Care Authority's decision to approve the cooperative agreement between the two hospitals. *Id*. According to the FTC, "[t]his case presents another example of healthcare providers attempting to use state legislation to shield potentially anticompetitive combinations from antitrust enforcement." *Id.*

By passing the West Virginia statute and approving the merger as a "cooperative agreement, the West Virginia Legislature may have immunized the merger from antitrust laws under the state action doctrine, which provides that federal antitrust laws do not apply to a state's anticompetitive conduct. *Parker v. Brown*, 317 U.S. 341, 351 (1943). The Supreme Court has extended state action immunity to anticompetitive restraints imposed by private actors, like the two hospitals here, where (1) the state's approval of the restraint is "clearly articulated and affirmatively expressed as state policy," and (2) the private conduct is "actively supervised" by the State. C*al. Retail Liquor Dealers Assoc. v. Midcal Aluminum*, 445 U.S. 97, 105 (1980). And it reaffirmed these two prongs in the context of another high-profile hospital merger dispute in Georgia. *FTC v. Phoebe Putney Health Sys., Inc.*, 113 S. Ct. 1003, 1010 (2013). The FTC's abandonment of the complaint suggests that it believes the West Virginia "cooperative agreement" law satisfies the two prongs of the state action doctrine.

Importantly, the FTC cautioned that it will continue to challenge anticompetitive mergers in the courts "and, if necessary, through state cooperative agreement processes." Id. at 3. The FTC also explained that its decision to dismiss the complaint without prejudice against these two hospitals does not necessarily mean that it "will do the same in other cases in which a cooperative agreement is sought or approved." *Id.*

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