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Expert Analysis

Court Refuses to Block Merger of Hospitals

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When the Patient Protection and Affordable Care Act[1] became law in 2010, one of its major goals was to encourage better quality and more cost-effective care across the spectrum of medical services. Since the law's enactment, we have witnessed unprecedented consolidations among health care providers: hospitals acquiring or merging with other hospitals, the formation of vast health care systems, the development of large physician practices, mergers and acquisitions among managed care plans and health insurers, and other combinations. Ironically, standing in the way of some of these consolidations have been the Antitrust Division of the U.S. Department of Justice, the Federal Trade Commission (FTC), and some state attorneys general, who have expressed concern over the effects of these consolidations on competition in the health care marketplace.

Hospital mergers have become a particular target for antitrust scrutiny. A decision earlier this month from a federal district court in Pennsylvania highlighted this conflict between consolidation and competition, and dealt a blow to the FTC's effort to stop the merger of two prominent health care systems in the commonwealth.

A federal district court in Pennsylvania highlighted the conflict between consolidation and competition.

Background

Penn State Hershey Medical Center is a major academic medical center in Hershey, Pa., and its 551-bed hospital is the primary teaching campus for the Penn State College of Medicine. Hershey offers a broad array of sophisticated high-acuity services, and operates central Pennsylvania's only specialty children's hospital, the only heart transplant center outside of Philadelphia and Pittsburgh, and one of three Level 1 trauma centers in Pennsylvania. Pinnacle Health System operates two community hospitals in Harrisburg and one in Cumberland County totaling 646 beds.

In June 2014, Hershey and Pinnacle entered into a Letter of Intent to merge, and their respective boards approved the merger in March 2015. The following month, the hospitals notified the FTC of their proposed merger, and in May 2015 they entered into a Strategic Affiliation Agreement.

The FTC reviewed the merger, and on Dec. 7, 2015, issued an administrative complaint alleging that the merger violated both Section 7 of the Clayton Act[2] (prohibiting mergers that may substantially lessen competition or tend to create a monopoly) and Section 5 of the FTC Act[3] (prohibiting unfair methods of competition in interstate commerce). On Dec. 9, 2015, the FTC and the Pennsylvania Attorney General jointly filed suit in federal district court challenging the merger. In the face of the hospitals' determination to proceed with their merger, the plaintiffs on March 7, 2016, filed a motion for a

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preliminary injunction. After intensive expedited discovery and submission of briefs, the court denied the motion in an opinion by District Court Judge John E. Jones III.[4]

In its decision, the court first noted that, in order to obtain an injunction under the FTC Act, the FTC must make "a proper showing that, weighing the equities and considering the [FTC's] likelihood of ultimate success, such action would be in the public interest."[5] The court then cited case law interpretations of §7 of the Clayton Act as requiring that there be a probability that a threatened merger would substantially lessen competition, and that neither "ephemeral possibilities" of anticompetitive effects nor a "fair or tenable chance of success on the merits" are sufficient to justify injunctive relief.

Moving onto substance, the court found that analysis of a potential Clayton Act violation requires a determination of the relevant product market and geographic market. The opposing parties had agreed that the relevant product market was "general acuity services" which "comprise a broad cluster of medical and surgical services that require an overnight stay," and that are sold to commercial insurance carriers. The court then turned to the relevant geographic market and cited the FTC's and Department of Justice's own definition of same as the smallest area in which a hypothetical monopolist could profitably raise prices by a "small but significant amount" for a meaningful period of time.[6]

Following its typical position that the market for hospital services is inherently local, the FTC asserted in this case that the relevant geographic market for general acuity services was the Harrisburg area, since patients who live in that area overwhelmingly utilize hospitals close to home, and few patients travel to hospitals outside of the Harrisburg area. The hospitals countered that the FTC's definition of the Harrisburg area as the relevant geographic market was far too narrowly drawn.

Again citing case law, the court found that it had to determine:

a) whether the FTC has alleged "a geographic market that includes an area in which a defendant supplier draws a sufficiently large percentage of its business"; and

b) whether the FTC has alleged "a geographic market in which only a small percentage of purchasers have alternative suppliers to whom they could practicably turn in the event that a defendant supplier's anticompetitive actions result in a price increase."

In the context of general acuity services, the court noted, this meant that the relevant geographic market is an area where few patients leave and few patients enter.

Turning to the evidence that had been presented during the hearing on the motion for a preliminary injunction, the court found it to be uncontroverted that in 2014, 43.5 percent of Hershey's patients, or 11,260 people, traveled to Hershey from outside of the Harrisburg area, and that several thousand of Pinnacle's patients also reside outside of the Harrisburg area. Moreover, half of Hershey's patients travel at least 30 minutes and 20 percent travel over an hour for care at Hershey, resulting in over half of Hershey's revenue originating outside of the Harrisburg area.

The court then addressed the FTC's assessment of the number of hospitals that patients could turn to if the Hershey-Pinnacle combination either raised prices or let quality of care decline. It found that there are 19 hospitals within a 65-minute drive of Harrisburg, many of which are closer to patients who now patronize Hershey, and could readily offer patients an alternative if the Hershey-Pinnacle combination raised prices.

The court also found "extremely compelling" the fact that the defendant hospitals had entered into five- and 10-year contracts, respectively, with CBC and Highmark, central Pennsylvania's two largest health insurers, representing 75-80 percent of both hospitals' commercially insured patients. The contracts require the hospitals to maintain existing rate structures for fee-for-service contracts and preserve the existing rate differential between the hospitals for the duration of the contract term.

The court reasoned that, since the hospitals cannot walk away from these insurers and cannot increase their rates to these insurers for at least five years, "the FTC is essentially asking the Court to

prevent this merger based on a prediction of what might happen to negotiating position and rates in 5 years." The court rejected the FTC's narrow market definition, and concluded that since the FTC had failed to set forth a relevant geographic market, it could not establish a prima facie case for injunctive relief under the Clayton Act, and had not demonstrated a likelihood of ultimate success on the merits.

Best Interests

The court next turned to weighing the equities to determine whether enjoining the merger would be in the best interests of the public. Reviewing the record, the court found that:

- Hershey's average patient capacity was generally 89 percent, and routinely climbed to 112-115 percent, when a hospital's optimal capacity is approximately 85 percent. A merger with Pinnacle would immediately make additional bed capacity available to Hershey.
- The merger would enable Hershey to transfer patients needing a lower acuity level of care to Pinnacle, thereby enabling Hershey to take in more higher level acuity patients and give them access to Hershey's range of more complex treatments and procedures.
- The ability to treat more patients at the facility best suited to the needs of those patients will enable both hospitals to generate more revenue.
- The merger could obviate the need for a new patient tower at Hershey, which Hershey executives estimated would cost $277 million to construct, thereby allowing Hershey to forgo this expenditure, serve more patients, and generate downward pricing pressure that greater efficiencies and a larger supply of services typically facilitates.

The court concluded:

> …the efficiencies evidence overwhelmingly indicates that procompetitive advantages would be generated for the Hospitals' consumers such that the equities favor the denial of injunctive relief.

Repositioning

The court then turned to the Horizontal Merger Guidelines jointly developed by the Department of Justice and the FTC as standards for determining whether mergers have anti-competitive effects. One of the guidelines deals with whether other competitors are able to "reposition" themselves, i.e., to offer very close substitutes to the products or services that the merging parties offered prior to their merger. Under the guidelines, if such repositioning is present, it could constitute a defense of the merger.

The court rejected the FTC's narrow market definition, and concluded that since the FTC had failed to set forth a relevant geographic market, it could not establish a prima facie case for injunctive relief under the Clayton Act.

The court, citing the acquisition of four local hospitals by four larger health care systems seeking to compete in the proposed Hershey-Pinnacle service area, found that such repositioning had already occurred and that it "represents a direct and concerted effort to erode both hospitals', but mainly Hershey's, patient base."

The court continued:

> Rather than monopolizing a geographic space, merging allows Hershey and Pinnacle to remain competitive in a climate where nearby hospitals are routinely partnering to assist each other in achieving growth and dominance. The rival hospitals' competitive strength will result in a meaningful constraint on competition, benefitting Harrisburg area residents in a manner consistent with the analysis set forth in the [Horizontal Merger] Guidelines.

Another factor considered by the court was the government's expressed intention to move Medicare away from fee-for-service payments and to shift 50-80 percent of payments to hospitals into risk-based contracts by 2018. In risk-based contracts, providers receive fixed per-capita payment for a designated population and assume the risks of providing care to that population, instead of charging a separate fee for each medical service provided. The court noted that not just the government but private health insurers are also moving to risk-based

contracts. Although it agreed with the FTC that Hershey and Pinnacle would independently be capable of continuing to operate under risk-based contracts, the court was persuaded that the larger scale of the merged Hershey-Pinnacle system would be better positioned to spread the costs of serving the populations covered under risk-based payment:

> Particularly as the payment models continue to shift, the local populace has a continued interest in seeing its most closely situated medical center remain competitive.

Lastly, the court addressed the issue of the public interest in effective antitrust enforcement when a preliminary injunction is sought. It found that the majority of factors in favor of the merger weighed in the public interest:

> The patients of Hershey and Pinnacle stand to gain much from a combined entity that is capable of competing with a variety of other merged and already growing hospital systems in the region. This decision further recognizes a growing need for all those involved to adapt to an evolving landscape of health care that includes, among other changes, the institution of the Affordable Care Act, fluctuations in Medicare and Medicaid reimbursement, and the adoption of risk-based contracting.

In closing, the court pointedly commented on the tension between the Affordable Care Act's encouragement of provider consolidations and the federal government's antitrust enforcement policies:

> Our determination reflects the health care world as it is, and not as the FTC wishes it to be. We find it no small irony that the same federal government under which the FTC operates has created a climate that virtually compels institutions to seek alliances such as the Hospitals intended here. Like the corner store, the community medical center is a charming but increasingly antiquated concept. It is better for the people they treat that such hospitals unite and survive rather than remain divided and wither.

Analysis

The FTC has indicated that it will continue to oppose this merger, and has filed an emergency motion to stay the merger pending an appeal to the U.S. Court of Appeals for the Third Circuit. It is important to note that this decision is limited to the FTC's and the Pennsylvania attorney general's motion for a preliminary injunction. The FTC's administrative proceeding challenging the merger is still ahead, and the federal court challenge awaits a full trial. Nonetheless, the decision is significant in that the court found that the plaintiffs' challenge had little likelihood of success, and it may encourage other federal courts to more aggressively scrutinize efforts by the FTC to enjoin hospital mergers.

As in many antitrust cases, the key is properly defining the relevant market and carefully assessing how much market power the merged entities will have. In the context of the health care marketplace, and in particular the market for general acuity hospital services, the court in this case has pointed out that there are other significant factors that it considered in performing its antitrust analysis (e.g., the changes wrought by the Affordable Care Act). The FTC may be unlikely to change its own criteria for reviewing hospital mergers, but it will be interesting to see if other courts weighing antitrust challenges to hospital mergers will adopt this more comprehensive analysis.

1. Public Law 111-148.
2. 15 USC §18.
3. 15 USC §4(a)(1).
4. *Federal Trade Commission and Commonwealth of Pennsylvania v. Penn State Hersey Medical Center and Pinnacle Health System*, No. 1:15-cv-2362, District Ct. M.D.Pa. May 9, 2016.
5. 15 USC §53(b).
6. U.S. Dept. of Justice and Federal Trade Commission, Horizontal Merger Guidelines, §4.1, 4.2 (2010).