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FTC HOSPITAL MERGER WIN STREAK ENDS: PA JUDGE RULES IN FAVOR OF HOSPITALS, BUT FTC FIGHTS ON

In the first big win in more than 10 years for hospitals over the Federal Trade Commission ("FTC") in a litigated hospital merger challenge, U.S. District Judge John E. Jones III of the Middle District of Pennsylvania ruled against the FTC, denying their request for a preliminary injunction to temporarily block the merger between Penn State Hershey Medical Center ("Hershey") and Pinnacle Health System ("Pinnacle"). Judge Jones rejected the FTC's definition of the relevant geographic market as too narrow and admonished the FTC for their opposition to mergers in an evolving health care environment that "virtually compels institutions to seek alliances such as the hospitals intended here." In a break from prior practice, however, the FTC is appealing the district court's decision rather than abandoning its challenge.

BACKGROUND

On December 9, 2015, the FTC, jointly with the Pennsylvania Office of the Attorney General, challenged the proposed merger between Hershey, a 551-bed hospital located in Hershey, Pennsylvania and Pinnacle, a nonprofit health system with 646 licensed beds across three campuses in the Harrisburg, Pennsylvania area. Hershey and Pinnacle operate the only three hospitals in Dauphin County and offer an overlapping range of general acute care services, including primary, secondary, tertiary and quaternary care. According to the FTC's complaint, the combined entity would have a post-merger market share of 64 percent and reduce the number of meaningful competitors from three to two in the "Harrisburg Area" (defined by the FTC as a four-county area roughly comprising the Harrisburg Metropolitan Statistical Area (Dauphin, Cumberland and Perry Counties) and Lebanon County).

RELEVANT GEOGRAPHIC MARKET

In its recent cases, relying in large part on its econometric modeling, the FTC has argued that the geographic market for general acute care services is inherently local because patients want to receive care close to where they live and work. Following this principle, the FTC defined the relevant geographic market as the Harrisburg Area, arguing that patients in Harrisburg overwhelmingly utilize hospitals close to home and very few travel to hospitals outside the Harrisburg Area. Hershey and Pinnacle disagreed, arguing that the FTC's geographic market definition was too narrow and ignored the commercial realities facing consumers. Judge Jones agreed with the hospitals.

In rejecting the narrow geographic market, Judge Jones employed a fact-specific analysis that proved to undermine the FTC's argument. The Judge noted Central Pennsylvania is largely rural and requires long driving distances for specific goods and services, including health care. In fact, the judge found 43.5 percent of Hershey's patients traveled to Hershey from outside the Harrisburg area. Further, half of Hershey's patients travel more than 30 minutes and 20 percent travel more than an hour to reach Hershey. As a result, over half of Hershey's revenue originated outside the FTC's defined geographic market. In determining whether patients could turn to other hospitals if the parties raised prices post-merger, the Judge found that within a 65-minute drive of Harrisburg there are 19 hospitals, many of which are closer to the patients who elect to commute to Hershey. The Judge found that these hospitals provide realistic alternatives for patients to utilize and can effectively keep Hershey and Pinnacle from raising prices post-merger.

MITIGATION OF POST-MERGER PRICE INCREASES

The Judge found it "compelling" that prior to the merger, Hershey and Pinnacle took steps to mitigate any potential post-merger price increases by negotiating long-term contracts with Capital Blue Cross ("CBC") and Highmark, Pennsylvania's two largest commercial payors representing 75-80 percent of Hershey's and Pinnacle's commercial patients. The hospitals executed a five-year contract with Highmark and a ten-year contract with CBC that require the individual hospitals to contract with the payors for those periods, maintain existing rate structures for fee-for-service contracts and preserve the existing rate differential between Hershey and Pinnacle.

While the FTC rejected this as nothing more than a litigation tactic that would not limit the hospitals from negotiating large price increases five years from now, the Judge found it persuasive. Coupling the fact that these agreements mean rates will not increase for at least five years with the reality that health care and health insurance is a rapidly changing area, the Judge found it imprudent to block the merger based on a prediction of what might happen to negotiating positions and rates in five years.

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THE EFFICIENCIES ARGUMENT

In opposing recent mergers, the FTC has thoroughly rejected any efficiencies arguments advanced by the merging parties, concluding that any suggested administrative, operational or clinical efficiencies were speculative in nature and not the "extraordinary" efficiencies necessary to outweigh the presumption of likely significant harm to competition under the FTC's Merger Guidelines – an almost insurmountable standard for hospitals. Here, despite relying exclusively on the issues with the FTC's geographic market in denying the preliminary injunction, the court went into a detailed discussion of the merits of the efficiencies generated by the proposed merger.

- Capacity/Quality Concerns

  Hershey indicated the need to build an additional bed tower to mitigate capacity shortages that resulted in their average capacity percentage ranging anywhere from 89-115 percent occupancy. Hershey proposed that, through the transaction, the need for an additional bed tower would be eliminated and would allow Hershey to admit more high-acuity patients while transferring low-acuity patients to Pinnacle facilities, allowing both hospitals' physicians to treat more patients and generate more revenue (further mitigating the need to impose post-merger price increases).

  The FTC challenged the proposition that Hershey needed to construct an additional bed tower to alleviate its capacity concerns. Among a number of reasons for rebuking this line of reasoning, the court highlighted its lack of authority to undermine the business decisions of an independent organization, stating that "it is not within our purview to question the CEO and COO's determination of this need, and their sworn testimony that they will embark upon this project absent the merger is sufficiently reliable."

- Repositioning by Competitors

  A major concern surrounding any potential merger is the loss of reasonable competitive alternatives post-merger. The theory goes that without reasonable alternatives, the merging parties will have market power resulting in the ability to raise prices. Often, merging parties will argue that the remaining competitors will have the ability to reposition themselves to offer close substitutes for the services offered by the merging parties and thereby keep the merging parties from raising prices. In this case, not only did the Judge find it was very possible that competitor repositioning would happen post-merger, the Judge found competitor repositioning was already happening *before* the merger. In the Harrisburg Area, the Judge found a number of competing hospitals have already undergone extensive repositioning to strengthen their competitive position relative to Hershey and Pinnacle. The court identified four specific acquisitions that were undertaken with the specific intent of taking patients from Hershey. The Judge found the merger does not result in Hershey and Pinnacle monopolizing the geographic space but rather allows Hershey and Pinnacle to remain competitive in a health care environment where nearby hospitals are forming alliances to grow and compete against Hershey and Pinnacle.

- Payor Contracting

  It is not breaking news that government and commercial payors are shifting payment methodologies towards risk-based contracting. A popular selling point put forth by merging parties is that, by merging, the resulting entities would be better equipped to provide a total continuum of care to meet the needs of capitated, risk-based payment methodologies and generate significant economies of scale and other efficiencies that will benefit the community, including enhancements to quality and services offered. The FTC has found these claimed efficiencies to be overstated, unverifiable and not "merger-specific" (i.e., the efficiencies could otherwise be achieved through avenues less restrictive than a merger). Although claimed efficiencies have always been viewed skeptically by the FTC, here, the court acknowledged this skepticism but found the parties' efficiency arguments persuasive, namely the ability to allocate the costs of population health management over a larger health system and the ability to use the additional revenue to support its College of Medicine.

- Health Reform Versus Antitrust Enforcement

  In one of the more colorful sections of the opinion, Judge Jones admonished the FTC for their outlook on hospital mergers and acquisitions in light of the current health care climate, stating that the court's ruling "reflects the healthcare world as it is, and not as the FTC wishes it to be." The court found "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 intend here," contrary to the FTC's repeated and firmly stated position that "meeting healthcare reform" is not a justification for any reduction in competition from a hospital merger. Further, the court went on to say that, "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 than remain divided and wither."

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PRACTICAL TAKEAWAYS

The District Court's decision provides some new items to keep in mind and resurrects some other issues for those considering a hospital merger.

- Determining the relevant geographic market is a critical component of any antitrust analysis in a hospital merger case. Given the court's willingness to reject the FTC's "inherently local" standard for defining relevant geographic markets, there may be room to define relevant geographic markets more broadly in the future and counter the FTC's econometric modeling with real market facts.
- Just when we though the efficiencies argument was dead in hospital mergers with relatively high market shares, we get a gasp of air. While the FTC's position of late has been that virtually no claimed efficiencies are sufficient to negate the anticompetitive effects of a merger, here, the court embraced the parties' efficiencies arguments. The court found that the merger would alleviate capacity constraints and permit the parties to avoid building an expensive new bed tower and seemed to breathe new life into the health care reform defense that merging hospitals have espoused since the ACA was enacted. Perhaps this is the beginning of more weight being given to certain efficiencies arguments.
- Long-term contracts with important payors may be helpful. Typically, the FTC is skeptical of such agreements because in the FTC's view, such agreements do not alleviate the increased market power post-merger. But given the court's willingness to credit such long-term contracts, it may be a strategy to consider in the future.

If you have any questions or would like additional information about this topic, please contact one of the following members of Hall Render's Antitrust practice group:

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