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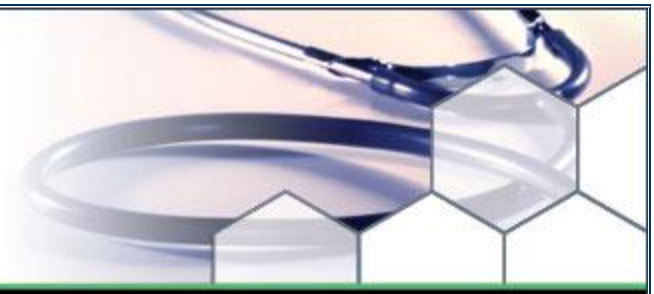

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Third Circuit Delivers Resounding Victory for FTC in Pennsylvania Hospital Merger Case

On September 27, 2016, the U.S. Court of Appeals for the Third Circuit handed the Federal Trade Commission (FTC) a significant antitrust victory by granting its request for a preliminary injunction to stay the pending merger (Merger) between Penn State Hershey Medical Center (PSHMC) and Pinnacle Health System. The Third Circuit reversed a Pennsylvania federal district court's May 2016 decision that would have allowed the Merger to proceed (see here for our analysis of that decision). This reversal bolsters the FTC's antitrust enforcement efforts after successive district court-level losses in hospital merger antitrust cases earlier this year. (In July, the Northern District of Illinois denied the FTC's and the State of Illinois' motion for a preliminary injunction to enjoin a proposed merger between Advocate Health Care and NorthShore University HealthSystem.)

The Third Circuit determined that the district court's antitrust analysis of the Merger "erred in both its formulation and its application" of the hypothetical monopolist test, the applicable standard for determining the relevant geographic market under Section 7 of the Clayton Act. The Third Circuit cited three specific deficiencies: (1) improper emphasis on patient in-flow data to hospitals in the proposed geographic area consistent with a discredited economic theory for health care mergers; (2) failure to "properly account for" the likely response of health insurers to a small but significant and nontransitory increase in price (SSNIP) on the basis that insurers are affected more acutely by such price increases than patients; and (3) misplaced reliance on rate-freeze contracts the hospitals had entered into with two major health insurers in the region as pro-competitive evidence, because the *hypothetical* monopolist test requires analysis of a hypothetical monopolist, so actual contractual restraints assumed by the hospitals to the Merger are not relevant. It is important to note that the Third Circuit emphasized that the hypothetical monopolist test is not the only test available to define a geographic market; in this case, all parties agreed that this was the proper standard to apply, and thus, others were not considered.

The Third Circuit then assessed the FTC's case and concluded that it had properly defined the relevant geographic market by presenting evidence demonstrating that the increase in the hospitals' post-Merger bargaining power would allow the post-Merger entity to profitably impose a SSNIP on health insurers. In support of its conclusion, the Third Circuit cited the fact that the post-Merger HHI (a measure of market concentration) is 5,984, well in excess of the 2,500 threshold for a "highly concentrated" market; the Merger's increase over the pre-Merger HHI is 2,582, where a 200 point increase is indicative of enhanced market power. The Third Circuit also cited deposition testimony from several insurance companies stating that they could not offer plans in the Harrisburg area without including the post-Merger entity. The Third Circuit thus held that the FTC had met its burden to demonstrate that the Merger is presumptively anticompetitive and turned to analyze the hospitals' Merger defenses.

The Third Circuit first considered the hospitals' "efficiencies defense" cited by the district court in support of the Merger. The efficiencies defense has been a feature of hospital merger defenses in recent years, albeit with limited success. The Third Circuit expressed significant skepticism that the efficiencies defense "even exists," noting the Clayton Act's silence on the issue and that neither the Third Circuit nor the Supreme Court had ever recognized the defense, despite multiple opportunities to do so. Without conceding its validity, the Third Circuit nonetheless addressed (and ultimately

rejected) the hospitals' efficiencies defense because the FTC's Merger Guidelines recognize it, and the district court had relied on the hospitals' claimed efficiencies in rejecting the FTC's request to stay the Merger.

The Third Circuit stated that, for an efficiencies defense to be cognizable, a defendant must show each of the following elements: (1) the efficiencies must offset the anticompetitive concerns in highly concentrated markets; (2) the efficiencies must be merger specific (cannot be achievable by alternate means); (3) the efficiencies must be verifiable, not speculative; and (4) the efficiencies cannot arise from anticompetitive reductions in output or service. Here, the hospitals presented two efficiencies defense claims: (a) the Merger would obviate the need for PSHMC to construct a new 100-bed tower to alleviate capacity constraints, and (b) the Merger would enhance the hospitals' efforts to engage in risk-based contracting. The Third Circuit found that the evidence is "ambiguous at best" that PSHMC needed to construct the new tower to alleviate overcapacity and emphasized that the Merger's HHI market concentration levels "eclipse any others" identified in similar hospital antitrust cases. As a result, the Third Circuit found that "extraordinarily great cognizable efficiencies are necessary to prevent the merger from being anticompetitive," and no such efficiencies existed in this case. The foregoing of construction of the new patient tower would also be a reduction in output, which the FTC Merger Guidelines expressly state may not be considered. Moreover, the Third Circuit found that the hospitals' ability to engage in risk-based contracting was not merger specific and that the hospitals failed to indicate how any risk contract savings would be passed on to consumers.

The Third Circuit also considered and rejected the hospitals' argument that the Merger would not produce anticompetitive effects, despite the high HHI numbers, because repositioning by competitors within the market would constrain post-Merger prices. The Third Circuit again cited expert testimony from health insurers regarding the impossibility of establishing a network in the Harrisburg area without either of the hospitals and that any repositioning by competitors would not constrain post-Merger prices. The Third Circuit therefore determined that the Merger's claimed efficiencies were insufficient to rebut the presumption of anticompetitiveness against the Merger and that the FTC had successfully shown its likelihood of success on the merits.

After concluding that the FTC had shown a likelihood of success on the merits, the Third Circuit then weighed the Merger's equities, the second prong for granting a preliminary injunction under Section 7 of the Clayton Act. The hospitals argued that granting the injunction would deprive the public of the Merger's benefits cited by the district court. The Third Circuit clarified that this argument misinterprets an equities analysis, as the hospitals' argument focused on the benefits of the Merger, whereas the proper consideration is whether the requested *injunction* is in the public interest. The Third Circuit concluded that any private equities cited by the hospitals cannot outweigh the public benefit of effective enforcement of antitrust laws, and therefore, the equities favor granting the injunction.

The Third Circuit thus remanded the case to the district court to enter a preliminary injunction of the Merger, pending the outcome of the FTC's administrative adjudication of the Merger; however, on October 14, after the Third Circuit issued its decision, the hospitals announced that they will terminate the proposed Merger. The court's focus on the public's interest in effective enforcement of antitrust laws, the substantial market concentration projections, and the hospitals' lack of a credible efficiencies argument appear to have doomed the proposed transaction.

If you have any questions, please contact a member of Robinson+Cole's Health Law Group:

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