The Third Circuit Hershey – Pinnacle Hospital Merger Decision

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Setting the Stage

The Parties

PENNSTATE HERSHEY

Milton S. Hershey Medical Center

- Penn State Hershey Medical Center ("Hershey") is a leading academic medical center and primary teaching hospital of the Penn State College of Medicine.
- Offers 551 beds and employs more than 800 physicians.
- As an AMC, Hershey draws patients from a broad area both inside and outside Dauphin County.

PINNACLEHEALTH

- Pinnacle Health System ("Pinnacle") is a health system with three hospital campuses – two located in Harrisburg in Dauphin County and the third located in Mechanicsburg in Cumberland County.
- Offers 646 beds and employs 300 physicians.
- Focus upon primary and secondary care.

Time Table on Deal and Litigation

- June 2014 – Hospitals sign Letter of Intent
- March 2015 – Boards approve the merger
- May 2015 – Strategic Affiliation Agreement
  - FTC HSR investigation starts
- December 7, 2015 – FTC files administrative complaint
- December 9, 2015 – FTC and Pennsylvania file district court lawsuit seeking preliminary injunction
- Expedited proceeding in district court
- April 2016 – District court holds five day evidentiary hearing (16 witnesses, thousands of pages of exhibits)
- May 9, 2016 – District court denies preliminary injunction
- May 24, 2016 – Third Circuit grants stay pending appeal and sets expedited schedule
- July 26, 2016 – Third Circuit argument
- September 27, 2016 – Third Circuit opinion

District Court Decision

- Judge takes "the healthcare 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 intend 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."
- Like many hospital merger cases, the district court opinion is centered on the relevant geographic market. Product market – inpatient general acute care ("GAC") services – was not contested.
- FTC, using the hypothetical monopolist test, argued that the relevant geographic market was the "Harrisburg (PA) area," roughly equivalent to the Harrisburg Metropolitan Statistic Area.
- However, the district court fixated on these facts:
  1. That 43.5% of Hershey's patients came from outside that area; and
  2. That half of Hershey's patients traveled at least thirty minutes for care, and 20% traveled over an hour for care.

District Court Decision – cont'd

- The district court felt that this "controverted" FTC's assertion that GAC services are inherently local, and that the FTC created a geographic market that was "unrealistically narrow and [did] not assume the commercial realties faced by consumers in the region."
- The district court discussed what it called the "equities" that also supported denial of the injunction:
    - Alleviation of Hershey capacity restraints
    - Foregoing construction of $277 million new bed tower
    - Assist in enabling the hospitals to do risk contracting
    - Repositioning of other hospitals
    - 5-year and 10-year contracts with payors freezing rates

District Court Decision – cont'd

And then there was the ACA.

- District court rejects the FTC's position that "the ACA neither requires nor encourages providers to merge or otherwise consolidate."

- Motion for preliminary injunction denied.

- A number of us believed that if the *Hershey* decision was affirmed on appeal, the FTC's whole approach to hospital merger enforcement would be in jeopardy.

- But that's not going to be the FTC's problem.

The Third Circuit's opinion is not only a win for the FTC.

BUT A BIG WIN

Standard of Review:

THE FTC GETS A CLEAN SECOND CHANCE

Standard of Review

- Normal standard of review:
  - Review findings of fact for clear error
  - Review conclusions of law *de novo*
  - Review ultimate decision to grant preliminary injunction for abuse of discretion

So what standard applies to geographic market determination?

- Courts, including Third Circuit, have reviewed relevant geographic market determinations for clear error
  - But here – not so fast:
  - The Third Circuit cites a 1975 case, *Am. Motors Inn:*

    "Although market definition is generally regarded as a question of fact, a trial court's determination of a market may be reversed where that tribunal erred as a matter of law."

- So: "where a district court applies an incomplete economic analysis of an erroneous economic theory to those facts that make up the relevant geographic market, it has committed legal error subject to plenary review."
- The court bolsters this approach by grabbing some dicta from a recent Supreme Court IP case, *Kimble v. Marvel Entm't*, 135 S. Ct. 2401, 2412-13 (2015): "the Supreme Court has felt relatively free to revise its legal analysis as economic understanding evolves and . . . to reverse antitrust precedents that misperceived a practice's competitive consequences."

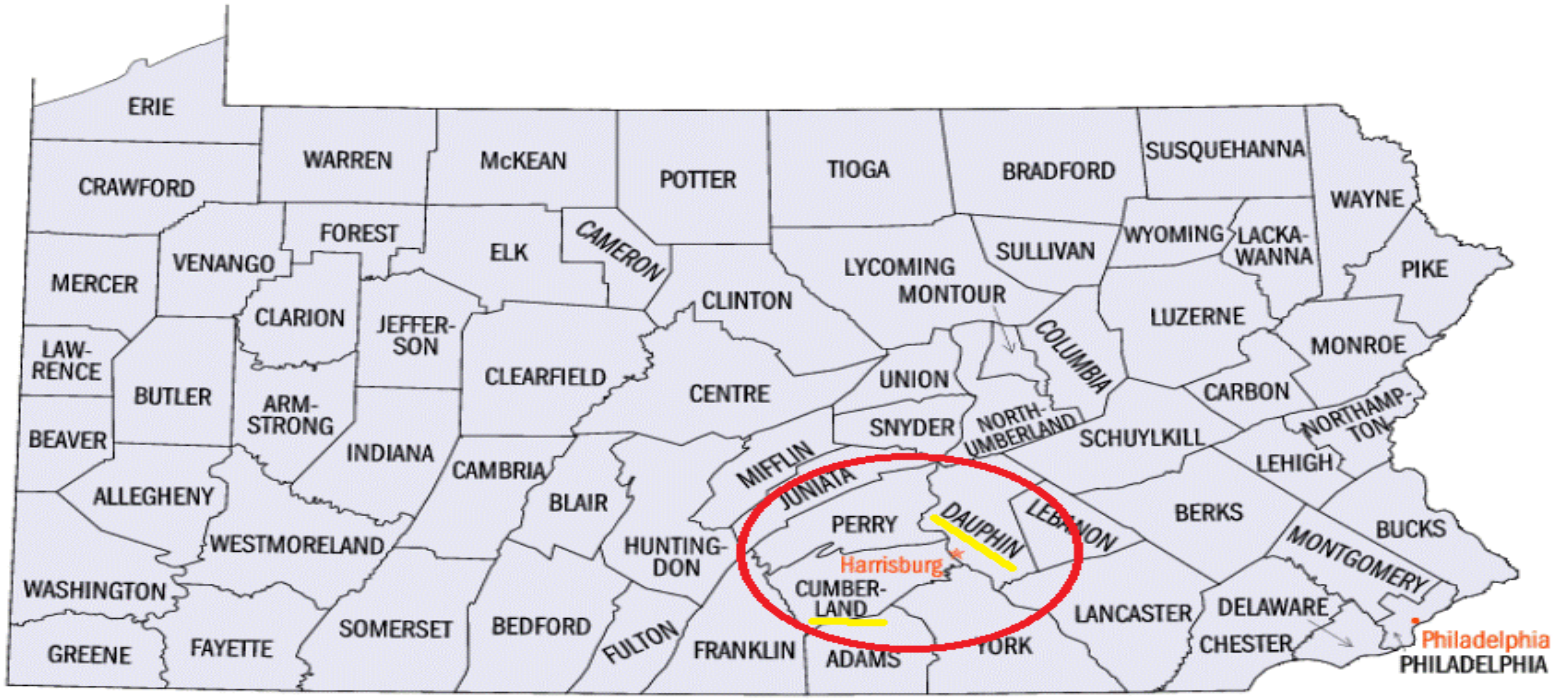
So here's the Third Circuit's magic trick:

- The parties agreed that the hypothetical monopolist test should determine the geographic market, and the district court purported to apply it.
- BUT the district court's application was incomplete and more closely mirrors an economic test that the FTC abandoned because – using *Kimble's* language – the test "misperceived . . . a practice's competitive consequences."
- SO – "although we accept all of the District Court's factual findings unless they are clearly erroneous, this failure to apply the correct legal standard, i.e., the economic theory behind the relevant geographic market, renders our review plenary."

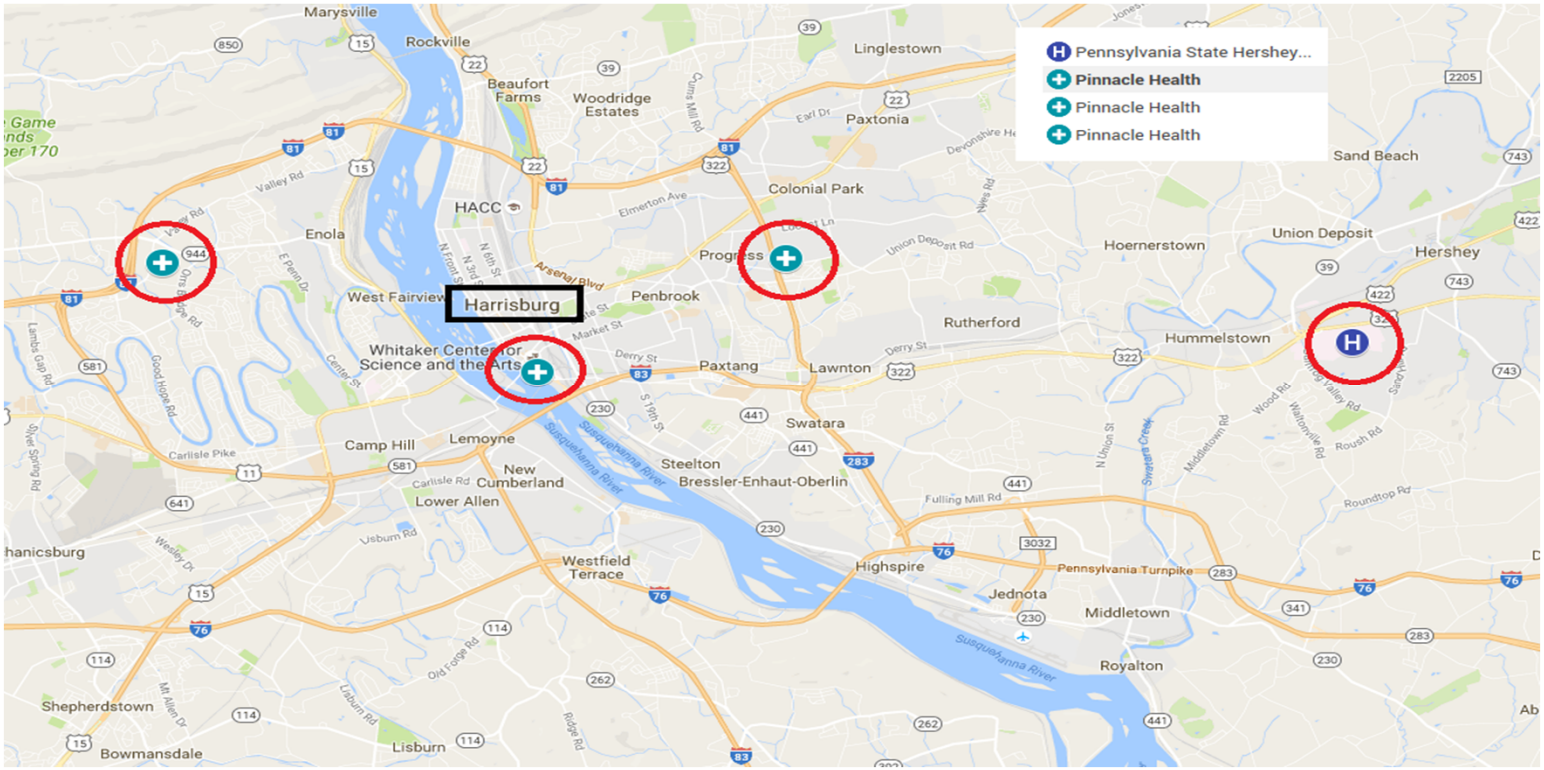
Likelihood of Success on the Merits

- At this stage, the FTC is not required to establish that the proposed merger will violate Section 7. Not a certainty, not even a high probability, need be shown.
- Burden Shifting Framework:
  - Government must establish a prima facie case that the merger is anti-competitive.
  - If government does so, burden shifts to Hospitals to rebut it.
  - If Hospitals rebut prima facie case, "the burden of production shifts back to the government and merges with ultimate burden of persuasion which is incumbent on the government at all times."

The Relevant Geographic Market



The Relevant Geographic Market – cont'd



- Relevant geographic market is:
  - "that area in which a potential buyer may rationally look for the goods or services he seeks."
  - an area that must "correspond to the commercial realties of the industry" and "be economically significant."

- For this effort, everyone agreed that the court should use the hypothetical monopolist test:
  - If a hypothetical monopolist could impose a small but significant non-transitory increase in price (known as a "SSNIP," often considered 5%), the market is properly defined.
  - If, however, consumers could defeat a SSNIP by purchasing the product from outside the market, making the SSNIP unprofitable, the proposed market definition is too narrow.

The Third Circuit found that the district court erred in its analysis in three ways:

First, it relied almost exclusively on the number of patients entering the proposed market – and thereby applied not the hypothetical monopolist test, but a discredited economic theory.

Second, the district court neglected any mention of the likely response of insurers.

Third, the district court relied in part on the private agreements between the hospitals and two insurers.

Discredited Legal Theory

- Although the district court never referred to it by name, the Third Circuit concluded that district court had applied one part of the Elzinga-Hogarty test.
- Like a detective, the court traced the district court's reliance on an Eighth Circuit case, *Little Rock Cardiology*, and then back to Elzinga-Hogarty. But the court in *Little Rock Cardiology* never said it applied the test.
- But *Little Rock Cardiology* cited a 1989 Illinois district court opinion, *Rockford Memorial*, that did.
- So then the Third Circuit sprang its *Kimble* trap:
  - Professor Elzinga himself had testified in the FTC *Evanston* case that this method "was not an appropriate method to define the geographic markets in the hospital sector."

Discredited Legal Theory – cont'd

- In this case, 36 economic professors – including Professor Elzinga – filed an amicus brief criticizing the use of patient flow data because of two problems: (1) The Silent Majority Fallacy and, (2) The Payor Problem.

  The Silent Majority Fallacy: the false assumption that patients who would travel to a distant hospital to obtain care significantly constrain the prices that the closer hospital charges to those who won't travel, relying solely on patient flow data; the percentage of patients who traveled to the AMC, Hershey, is not consistent with the hypothetical monopolist test.

  The district court also failed to consider that 91% of patients in Harrisburg receives GAC services in the Harrisburg area.

Likely Response of Payors

- The Payor Problem: The district court neglected any mention of insurers in the healthcare market, which ignored the commercial realities of the healthcare market because insurers are the largest "buyers" of hospital services.
  - The Third Circuit embraces a two-stage model of competition in healthcare markets.
    - First stage – hospitals compete to be included in an insurance plan's hospital network.
    - Second stage – hospitals compete to attract individual members of an insurance plan.
- Patients, in large part, do not feel the impact of price increases – insurers do. They negotiate the reimbursement rates.

Likely Response of Payors – cont'd

- So, "when we apply the hypothetical monopolist test, we must also do so through the lens of the insurers; if enough insurers, in the face of a small, but significant non-transitory price increase, would avoid the price increase by looking to hospitals outside the proposed geographic market, then the market is too narrow."
- Here payors testified that they could not successfully market a plan without Hershey and Pinnacle in the Harrisburg area.
- And the one payor that tried, dropping Pinnacle from a network that also did not have Hershey, lost half of its membership.

Private Pricing Agreements

- The Hospitals had entered into contractual arrangements that would be effective post merger, and that maintained the existing rate structure for five years with payor A and 10 years with payor B.
- The district court found these arrangements very pertinent, saying that the FTC was "asking the Court [to] prevent this merger based on a prediction of what might happen to negotiating positions and rates in 5 years."
- To the Third Circuit:
  - The district court's "reasoning is flawed."
  - "The hypothetical monopolist test is exactly what its name suggests: hypothetical."
  - Even considering private contracts, even if not relying upon them, is error.
  - "Determination of the relevant geographic market is a task for the courts, not the merging parties."
  - We can't let merging parties "impermissibly broaden the scope of the relevant geographic market. This would enable antitrust defendants to escape effective enforcement of the antitrust laws."

Therefore:

"Because our antitrust analysis must be consistent with the evolution of economic understanding, *Kimble*, 135 S. Ct. at 2412-13, and must be tied to the commercial realities of the specific industry at issue, *Brown Shoe*, 370 U.S. at 336, we hold that the District Court committed legal error in failing to properly formulate and apply the hypothetical monopolist test."

And Furthermore:

"The government has properly defined the relevant geographic market."

- Insurers would have no choice but to accept a price increase.
- There could be no Harrisburg networks that didn't have at least one of the hospitals.
- Payors considered Harrisburg a distinct market.

- Third Circuit rejects the argument that insurers have plenty of leverage in negotiations, saying that the only issue is whether the merger changes Hospitals' bargaining leverage so that they could profitably impose a SSNIP.

Once FTC won the geographic market war,
it had clear sailing to carry
its burden on the prima facie case.

- **The HHIs were formidable:**
- Post-merger HHI was 5,984.
- Increase in HHI was 2,582, well beyond the 200-point increase that is presumed to enhance marker power.
- Post-merger market share would be 76% in Harrisburg.
- "Together, these numbers demonstrate that the merger is presumptively anticompetitive."

Rebutting the Prima Facie Case

The decision was a "Black Tuesday" for efficiency arguments in hospital merger cases.

- First of all, the Third Circuit was very reluctant to even consider the efficiencies defense. "[W]e are skeptical that such an efficiencies defense even exists."
- Said it had never formally adopted the efficiency defense.
- Said Supreme Court hadn't either.
- But recognized that other courts of appeals have, and that the Merger Guidelines do recognize the relevance of efficiencies.
- So it decided to consider the Hospitals' arguments – in order to reject them.

Hospitals' Capacity Restraints and Capital Savings Claims

REJECTED:

- Capital savings must be verifiable, merger specific, result in some tangible verifiable benefit to consumers, and not result in any anticompetitive reduction in output.
- **BUT HERE:**
  - Evidence is ambiguous at best that Hershey needed to construct a 100-bed tower to alleviate capacity constraints.
  - And it is an impermissible reduction in output.
  - And no showing how it benefits consumers.

Merger Will Help Efforts to Engage in Risk-Based Contracting

REJECTED:

- No showing that benefit would be passed on to consumers.
- Both capable of independently engaging in risk-based contracting – therefore efficiency is not merger specific.

Repositioning by Competitors will be Sufficient to Constrain Post-Merger Prices

REJECTED:

- A lot of repositioning (i.e. other mergers) have already occurred.

- However, repositioning by other hospitals would not "have the ability to constrain post-merger prices, as evidenced by the extensive testimony by payors that there would be no network without Hershey and Pinnacle."

And with the type of HHIs in this case, "extraordinarily great cognizable efficiencies [are] necessary to prevent the merger from being anticompetitive."

-- Citing to Merger Guidelines § 10 at 31.

But what about the Affordable Care Act (ACA) and the tension between antitrust and the goals of the ACA?

The ACA is never mentioned in the opinion.

Tucked away on page 45 of the opinion is this statement:

"On balance, the equities favor granting the injunction. None of the private equities, or those equities that may have public benefit, on the Hospitals' side of the ledger are sufficient to overcome the public's strong interest in effective enforcement of the antitrust laws. We recognize that certain extrinsic factors have made these types of mergers beneficial—perhaps even necessary—to the continued success of some hospital systems. Yet, in this case, we are tasked with deciding only whether preliminary injunctive relief would be in the public interest. Opining on the soundness of any legislative policy that may have compelled the Hospitals to undertake this merger is not within our purview."

Now what?

- This opinion will help the FTC in the Seventh Circuit *Advocate/North Shore* case.
- Both the FTC and *Advocate/North Shore* have already filed letters with the Seventh Circuit arguing the impact of *Hershey*.

-The FTC's hospital merger program is alive and well, with the wind at its back again.

- The FTC's skepticism about hospitals' efficiency arguments is now back-stopped by a strong appellate court opinion.

Is it the end of this case and this merger?

Questions?

Thank you!

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