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Client Alert

Business Litigation & Antitrust Practice Group

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FTC Wins on Appeal in the Third Circuit to Block Hershey Medical Center and PinnacleHealth System Hospital Merger

On September 27, 2016, the U.S. Court of Appeals for the Third Circuit reversed a district court decision that the Federal Trade Commission and the state of Pennsylvania could not block the merger of two hospital systems, holding that the FTC and Pennsylvania successfully demonstrated the merger would violate Section 7 of the Clayton Act. The lower court, the U.S. District Court for the Middle District of Pennsylvania, is expected to enter a preliminary injunction against the merger on remand.

Hershey Medical Center is a 551-bed teaching hospital owned by Penn State University College of Medicine, located in Hershey, Pennsylvania. Hershey employs over 800 physicians, and has also entered into partnerships with other hospitals to provide outpatient services such as endoscopies, trauma treatment, and surgeries. PinnacleHealth System owns three hospitals—two in Harrisburg and one in Mechanicsburg—that provide mainly primary and secondary general acute care services. According to the FTC, Hershey and PinnacleHealth are the two largest hospital providers in Harrisburg and its surrounding areas.

Hershey and PinnacleHealth entered into an agreement to merge in June of 2014, and the agreement was approved by the hospitals' boards of directors in March of 2015. Following an investigation of this proposed merger, the FTC filed a complaint in district court seeking a preliminary injunction to enjoin the transaction pending an administrative trial. The FTC argued that the combined system would control 76 percent of the market for general acute care services in Harrisburg, PA and have a number of anticompetitive effects, including enhancing bargaining leverage with payors and decreasing quality.

The District Court ruled against the FTC on May 9, 2016, largely on the grounds that the FTC's definition of the geographic market for health care in and around Harrisburg—the four counties encompassing and surrounding Harrisburg—was "unrealistically narrow." Notably, the District Court stated that "19 hospitals within a 65 minute drive of Harrisburg" would "offer consumers an alternative" post-transaction based on patient inflow data and it ignored the views of commercial payors.

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The Third Circuit Court reversed in a unanimous opinion, holding that "[E]rrors … render the district court's analysis economically unsound and not reflective of the commercial reality of the healthcare market." First, according to the Third Circuit, the District Court's geographic market analysis was flawed. Specifically, the District Court failed to consider the "undisputed evidence that 91% of patients who live in Harrisburg receive GAC [general acute care] services in the Harrisburg area," meaning that most patients who live in Harrisburg do not turn to hospitals outside of the Harrisburg area to get GAC services.

Second, the District Court's analysis focused only on the response of patients to a price increase resulting from the Hershey-PinnacleHealth merger, and "neglected any mention of the insurers in the health care market." The court acknowledged that patients are "relevant" to the antitrust analysis, but stated that commercial payors are the parties that bear the "immediate impact of that price increase" and thus any analysis of a transaction's potential anticompetitive effects must include the effect upon the rates payors pay for services.

Third, the Third Circuit Court ruled that the District Court should not have considered Hershey and PinnacleHealth's existing agreements with insurers when it contemplated how a merged Hershey-PinnacleHealth might attempt to affect prices. The District Court had incorrectly reasoned that, even if Hershey and PinnacleHealth were to merge, the merged hospital would be significantly restrained in its ability to raise prices. However, the Third Circuit Court ruled that "private contracts are not to be considered" and that the courts should "answer whether a *hypothetical* monopolist [unburdened by existing private contracts] could profitably [increase prices]."

Perhaps most notably, the Third Circuit Court rejected Hershey and PinnacleHealth's claim that the merger would create efficiencies sufficient to offset the transaction's anticompetitive effects and cast doubt on whether a defense to a merger based on its alleged efficiencies even exists, stating: "we have never formally adopted the efficiencies defense. Neither has the Supreme Court. Contrary to endorsing such a defense, the Supreme Court has instead . . . cast doubt on its availability." Having reviewed the hospitals' claimed efficiencies, the Court held that they failed to meet the "demanding scrutiny the efficiencies defense requires" because the evidence was "ambiguous at best" that they were verifiable and would not result in any anticompetitive reduction in output.

Takeaways

This is a significant win for the FTC. For one, it helps preserve the FTC's model for analyzing hospital mergers: a two-stage model of competition that takes into account price effects for insurers and that tends to assume narrow geographic markets. The District Court's decision was the first defeat of an attempted federal court hospital merger challenge in more than 10 years for the FTC (a subsequent loss in Illinois is on appeal to the Seventh Circuit). In addition to casting serious doubts on the FTC's hospital merger model, the District Court opinion was very critical of the FTC's insistence on challenging provider combinations when the Affordable Care Act created significant incentives for consolidation. It therefore would have been devastating for the FTC to lose the appeal. Moreover, the Third Circuit decision heavily emphasizes the importance of payors in assessing a transaction's competitive effects, even if payors reach favorable agreements with the merging parties to preserve their rates. The Third Circuit decision also raises serious concerns about whether efficiencies evidence has any probative value in court. Finally, it reminds us that the FTC is showing no signs of slowing down in their investigations and challenges of provider combinations.