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Client Alert: Third Circuit Reverses Denial of Preliminary Injunction in Pennsylvania Hospital Merger

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Last Tuesday, the U.S. Court of Appeals for the Third Circuit reversed a Pennsylvania district court's decision denying a preliminary injunction in the Federal Trade Commission's (FTC) and Commonwealth of Pennsylvania's (collectively, the government) challenge to a merger between Pinnacle Health System (Pinnacle) and Penn State Hershey Medical Center (Hershey) (collectively the hospitals). In denying the preliminary injunction, the district court concluded that the Government failed to define a cognizable geographic market and that the equities supported denying the injunction.

On appeal, the Third Circuit determined that the lower court erred in the formulation and application of the "hypothetical monopolist" test used to define the relevant geographic market. Specifically, the court of appeals concluded that the district court improperly used an analysis closely resembling an outdated economic method, and did not sufficiently take into account and make allowances for the intricacies of the healthcare marketplace. The lower court's analysis relied heavily on patient flow and diversion data—in other words, the likely response of patients to the proposed merger—rather than evaluating the likely effect of the merger on impacted commercial insurance payors, which are the more relevant and price sensitive customers in the market for general acute care hospital services. As the court of appeals explained, "[p]atients are relevant to the analysis, especially to the extent that their behavior affects the relative bargaining positions of insurers and hospitals as they negotiate rates. But patients, in large part, do not feel the impact of price increases. Insurers do." In short, because the district court's approach "failed to properly account for the likely response of insurers in the face of a [price increase]," it "reflect[ed] a misunderstanding of the 'commercial realities' of the healthcare market" and was "economically unsound." The Third Circuit also concluded that the district court's consideration of certain private pricing agreements between the hospitals and payors, under which the hospitals agreed to maintain existing rates for at least five years, was inappropriate because such agreements are legally irrelevant when conducting a market analysis.

Properly applied by the Third Circuit, the hypothetical monopolist test in the Pinnacle-Hershey merger resulted in a much narrower market than the one identified by the district court. With this narrower, more accurate market definition, the government easily met its burden of establishing a prima facie case of anticompetitive effects. The Third Circuit found that the resulting post-merger market would be more than twice the standard of a highly concentrated market using the Herfindahl-Hirschman Index (HHI). In rejecting the hospitals' asserted procompetitive efficiencies, the Third Circuit initially questioned whether a viable efficiencies defense truly exists, noting that, to the extent it does, it must adhere to a rigorous standard and the efficiencies "must be merger specific, verifiable, and must not arise from any anticompetitive reduction in output or service." The hospitals' claimed efficiencies—which related to capital cost savings and ability to engage in risk-based contracting—did not meet this standard, particularly given the fact that "extraordinarily great cognizable efficiencies" would be required given the level of anticompetitive effect forecasted by the HHI numbers.

The FTC's victory in the Third Circuit follows a string of losses for the FTC in the hospital merger realm. In July 2016, the FTC dropped its challenge to the merger of two West Virginia hospitals after the state passed a law protecting hospital mergers from state and federal antitrust scrutiny. Shortly before, the Northern District of Illinois denied the FTC's request for a preliminary injunction in its challenge to the Advocate-NorthShore merger in Chicago, and the FTC's appeal of that decision is currently pending before the Seventh Circuit. The Third Circuit ruling may have implications for the Seventh Circuit case, however, as the Chicago case was also decided, in large part, on a geographic market analysis that relied on patient flow data and diversion ratios. At oral arguments in the FTC's appeal of the Northern District of Illinois decision, the Seventh Circuit panel already expressed skepticism regarding the district court's analysis, indicating that "it went off the rails at the district court because of this geographic market issue." That commentary from the Seventh Circuit panel, combined with the Third Circuit decision may portend a reversal of fortunes for the FTC in the Advocate-NorthShore case as well.