# *FTC V. PENN STATE HERSHEY MEDICAL CENTER*: THIRD CIRCUIT APPEAL COULD LEAD TO IMPORTANT DECISION FOR FUTURE HOSPITAL MERGERS

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## I. INTRODUCTION

On May 9, 2016, District Judge John E. Jones III of the Middle District of Pennsylvania denied a joint motion by the Commonwealth of Pennsylvania and the Federal Trade Commission ("FTC") seeking a preliminary injunction to enjoin the proposed merger of Penn State Hershey Medical Center and PinnacleHealth System while the FTC conducted a full administrative trial on the merits of the transaction. Judge Jones rejected the request for an injunction based on his holding that the government had failed to define a proper geographic market – in particular, finding that the "Harrisburg Area" geographic market proffered by the plaintiffs was "unrealistically narrow and [did] not assume the commercial realities faced by consumers in the region."[2]

Judge Jones also discussed at some length the "equities" of the transaction. He focused in particular on the importance of alleviating capacity constraints and avoiding construction of a new patient bed tower, which the court concluded represented a "compelling efficiencies argument" for the merger.[3] His decision concluded with an unusually pointed critique of the FTC's hospital merger enforcement priorities. Judge Jones expressed

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[2] *Federal Trade Commission et al. v. Penn State Hershey Medical Center et al.*, No. 1:15-cv-02362-JEJ, 2016 WL 2622372, at *4 (M.D. Pa. May 9, 2016).

[3] Id. at *5.

the view that the litigation brought by the FTC could be considered "no small irony [when] 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."[4]

The FTC appealed the decision to the Third Circuit, and oral argument was held on July 26, 2016. Although the FTC raised a number of concerns about the decision below, it focused its appeal on geographic market definition and argued that Judge Jones' analysis of the relevant geographic market was incorrect as a matter of law. The resulting decision could offer a useful clarification regarding the appropriate method to determine the relevant geographic market – and in that scenario, a loss might force the FTC to rethink its approach to hospital merger enforcement.

## II. ANALYSIS

In addition to challenging the framework Judge Jones used to analyze the geographic market (and his purported reliance on temporary "price protection" agreements the parties recently entered into with the two largest area health insurers), the FTC also took issue on appeal with how Judge Jones weighed the equities and analyzed efficiencies, his statements regarding the Affordable Care Act, and, by implication, the standard Judge Jones used in ruling on the preliminary injunction motion under Section 13(b) of the FTC Act. Each of these points is discussed in turn below.

### *A. Geographic Market Definition*

Until this case, the proper method for determining a geographic market in hospital merger cases seemed to have been settled, but that issue has received a great deal of attention recently. The FTC suffered a string of losses in hospital merger challenges, dating back to the 1990s,[5] based primarily on what it believed to be overly broad geographic market definitions found by courts relying on what has been called the Elzinga-Hogarty test. That test looks at patient in-flow and out-flow statistics from putative geographic markets to determine whether such areas are susceptible to post-merger price increases (i.e. a small but significant non-transitory increase in price ("SSNIP")) by a hypothetical monopolist.

In 2003, the FTC and United States ("U.S.") Department of Justice ("DOJ") embarked on a major "retrospective" of hospital competition, including assessing the competitive effects of several consummated hospital mergers.[6] This retrospective concluded that some of those mergers had generated anticompetitive effects and led the FTC and the DOJ to a paradigm shift in how they approached geographic market definition. The agencies began to focus on "willingness to pay" modeling and emphasized whether a proposed transaction

[4] Id. at *9.

[5] See, e.g. *FTC v. Tenet Health Care Corp.*, 186 F.3d 1045 (8th Cir. 1999); *FTC v. Freeman Hosp.*, 69 F.3d 260 (8th Cir. 1995).

[6] "FTC Chairman Announces Public Hearings on Health Care and Competition Law and Policy to Begin in February 2003," available at https://www.ftc.gov/news-events/press-releases/2002/11/ftc-chairman-announces-public-hearings-health-care-and ; see also FTC and DOJ, *Improving Health Care: A Dose of Competition* (2004), available at https://www.ftc.gov/sites/default/files/documents/reports/improving-health-care-dose-competition-report-federal-trade-commission-and-department-justice/040723healthcarerpt.pdf.

would enhance the merged hospital's bargaining leverage with insurers over rates – i.e. whether a hypothetical monopolist could impose a SSNIP on an insurer. This new approach has over time been widely accepted in the courts, and the FTC has won a series of hospital merger cases over the past decade using that framework.[7]

Judge Jones' decision in *Penn State Hershey* seemed to harken back to the earlier analytical approach of relying on patient flow statistics. In his decision, he noted that the "end goal" in the relevant geographic market analysis was to determine the area where "few patients leave…and few patients enter" i.e. to define an area from which the defendant hospitals draw the bulk of their patients, with few patients entering from outside that area to seek medical care and few patients within that area leaving to seek care from other hospitals.[8] Thus, the court found it highly probative that a significant fraction (43.5 percent) of Penn State Hershey's patients traveled to the hospital from outside the FTC's proposed Harrisburg Area geographic market, while "several thousand" of Pinnacle's patients lived outside of it.[9]

The FTC argued on appeal that Judge Jones "failed to properly formulate and apply the test" for the relevant geographic market and that the court erred as a matter of law.[10] The FTC asserted that Judge Jones "wholly ignored the role of the relevant buyers – insurers" and instead the court's analysis focused exclusively on the single patient in-flow statistic from Penn State Hershey.[11] The FTC argued that the court's reliance on this patient in-flow statistic meant, in effect, that Judge Jones had applied the "discredited" Elzinga-Hogarty test, which "has been rejected for use in analyzing hospital mergers by the FTC and by its own creator."[12] The FTC went on to note that "[n]o recent court has used the [Elzinga-Hogarty] analysis" but that courts instead have "scrutinize[ed] the relative bargaining power of healthcare providers and insurers."[13]

The merging parties contest the FTC's characterization of the case below and instead cast the appeal as a "straightforward factual dispute" about the record evidence that should thus be reviewed under the "clear error" standard.[14] The factual dispute, in their view, was whether a hypothetical monopolist in the alleged Harrisburg Area geographic market would in fact be able to overcome insurer resistance and successfully implement a post-transaction SSNIP when the evidence indicated a significant number of hospital patients were willing to travel significant distances for care.[15]

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[7] See, e.g. *St. Alphonsus Med. Ctr. – Nampa, Inc. v. St. Luke's Health Sys., Ltd.,* 778 F.3d 775 (9th Cir. 2015); *ProMedica Health Sys. v. FTC*, 749 F.3d 559 (6th Cir. 2014).

[8] *Penn State Hershey,* 2016 WL 2622372, at *3 (internal quotations omitted).

[9] Id. at *4.

[10] See FTC Brief at 31.

[11] Id. at 36.

[12] Id. at 40 n.7.

[13] Id.

[14] Brief of Appellees Penn State Hershey Medical Center and PinnacleHealth System at 15,17, *Federal Trade Commission et al. v. Penn State Hershey Medical Center et al.*, No. 16-2365 (3d Cir. June 13, 2016) (hereinafter "Hospitals' Brief").

[15] Id. at 17. The hospitals also take issue with the FTC narrative about the evolution of hospital merger jurisprudence, arguing that the "different outcomes" over time were due to "different facts," not the result of "some sudden discovery of how healthcare bargaining works." Id. at 33.

### B. *"Price Protection" Agreements*

Judge Jones also noted (in the context of assessing whether a hypothetical monopolist of the alleged Harrisburg Area geographic market would be able to extract a SSNIP) that the hospitals had recently entered into rate agreements with their two largest insurers. The court emphasized that these agreements maintained existing rate structures and the rate differential between the hospitals for several years.[16] In its appeal, the FTC argued that the court incorporated the existence of these agreements into its analysis of the geographic market and that doing so represents an "unprecedented departure" from legal precedent and the Merger Guidelines approach used by U.S. antitrust enforcers.[17] In particular, the FTC argued in its briefing that the court misunderstood the entire point of the hypothetical monopolist test, which "*necessarily* assumes that customers face the SSNIP, unprotected by a contract."[18] Further, the FTC argued that Judge Jones' framework would have "troubling implications" for future cases, allowing merging parties to disrupt the proper definition of a geographic market merely by entering into an agreement with insurers to limit price increases for a few years.[19]

The hospitals argue that the FTC "misread[s] the court's opinion" and assert that Judge Jones had already reached his conclusion on the geographic market and was merely referencing the agreements as part of his discussion, not relying on them as a basis for his determination.[20] The Third Circuit decision on this point seems likely to turn on whether the appellate court views these agreements as integral to Judge Jones' geographic market analysis.

### C. *Efficiencies*

The FTC also argued in its appeal that the court committed legal error by weighing the equities of the transaction with insufficient rigor. The FTC argued that had the district court correctly found in favor of the FTC with regard to geographic market definition, the court would have found the proposed merger presumptively illegal, and thus the burden would have shifted to the hospitals to demonstrate "extraordinary efficiencies." Because the hospitals were "never put…to the burden of crossing that hurdle," the court never performed the "rigorous analysis" required to prove efficiencies, and instead embarked on a "gratuitous discussion of the 'equities'" that did not meet the requirements for the formal "efficiencies defense" – that the claimed efficiency was "merger-specific," "verifiable," and not

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[16] *Penn State Hershey*, 2016 WL 2622372, at *4.
[17] FTC Brief at 47.
[18] Id. at 44-45 (emphasis in original).
[19] Id. at 47. It is not surprising that the FTC has contested the court's opinion on this issue. The FTC routinely rejects short-term rate commitments as a cure for what it finds to be otherwise anti-competitive transactions. FTC Chairwoman Edith Ramirez reiterated this point in a speech after the *Penn State Hershey* decision, noting that "these kinds of arrangements fail to replicate the benefits of competition." Leah Nylen, *Ramirez Bashes Efforts to 'Sidestep' Federal Antitrust Scrutiny in Healthcare*, MLex, May 12, 2016, *available at* http://www.mlex.com/GlobalAntitrust/DetailView.aspx?cid=794272&siteid=191&rdir=1 (subscription).
[20] Hospitals' Brief at 36-37.

"speculative."[21]

Specifically, the FTC contended that what the district court credits as an efficiency – the opportunity to avoid building a new patient bed tower – is actually a "classic reduction in output that will lead to higher prices."[22] The hospitals responded that a new patient bed tower may add beds, but may not expand output (i.e. hospital services for patients), while the merger would immediately expand output by enabling the hospitals to better allocate patients between them, and thus that the court correctly credited the claimed efficiency. More broadly, the hospitals object to the notion that the court (and they) should be held to the formal efficiencies standard when the burden never shifted and thus the hospitals were not required to prove an efficiencies defense.[23]

Efficiencies are rarely the issue on which any merger case turns, and it seems unlikely that the issue would rise to that level in this instance. In general, antitrust courts are skeptical of efficiencies claims and that has been true in recent hospital merger cases as well.[24] In this instance, while it is true that the burden-shifting framework had not been triggered, it also seems clear that the lower court did not conduct the usual rigorous analysis of efficiencies that one might expect if, in fact, a court were to rely on them. The lack of extensive analysis, and the fact that the court explicitly stated that it did not rely on efficiencies as part of its decision, makes it unlikely that efficiencies would be a pivotal part of the appellate decision.

*D. The Affordable Care Act*

The FTC argued that the court committed legal error when it condemned the FTC for seeking to block a transaction that the court believed was undertaken in response to the Affordable Care Act and the regulatory structure created by the federal government.[25] The FTC noted that the "Clayton Act contains no healthcare exception" nor does the Affordable Care Act contain an antitrust exemption, and contended that the court's views infected its decision, but this issue received limited treatment in the FTC brief.[26] The hospitals also treated it as a side issue, noting in a footnote that Judge Jones was merely making a "well-founded observation" that the merger would help the hospitals adapt to the changing health care environment.[27] Judge Jones' statement on the issue seems best viewed as dicta, which likely

[21] FTC Brief at 47-49.
[22] Id. at 50.
[23] Hospitals' Brief at 38-39, 43. Judge Jones would likely agree with the hospitals in this regard; he states in his opinion that his discussion of efficiencies was "not relevant as a defense to illegality" because he had already found the merger legal (because the FTC had failed to prove the geographic market). *Penn State Hershey*, 2016 WL 2622372, at *5.
[24] See, e.g. *Saint Alphonsus Medical Center-Nampa Inc. v. St. Luke's Health System, Ltd.*, 778 F.3d. 775, 790-91 (9th Cir. 2015).
[25] Such views stand in direct opposition to the FTC's long-held position on this issue. The FTC has stated numerous times that it believes that antitrust enforcement is a complement to the new health care environment: "The goals of the [Affordable Care Act] are in harmony [with antitrust enforcement] and not in conflict….There are other practical ways of achieving coordinated care and alternative payment models beyond merging with a close competitor." See http://www.commonwealthfund.org/publications/newsletters/washington-health-policy-in-review/2015/dec/dec-21-2015/obamacare-antitrust-laws-can-coexist (quoting Deborah Feinstein, Director of FTC's Bureau of Competition); *cf. St. Luke's Health System, Ltd.*, 778 F.3d. at 781 ("As the district court recognized, the job before us is not to determine the optimal future shape of the country's health care system, but instead to determine whether this particular merger violates the Clayton Act.").
[26] FTC Brief at 57.
[27] Hospitals' Brief at 47 n.20.

explains why neither side made it a focus on appeal. But the issue does offer some insight into the lower court's views and may affect the approach of the appellate court on the margins.

*E. Standard of Review*

The FTC also suggested in its brief that Judge Jones held it to a more stringent standard of review than is appropriate under Section 13(b) of the FTC Act. Although the district court recognized that an application under Section 13(b) is subject to a different standard than the traditional preliminary injunction standard (which must be met by private parties and the DOJ), the court did not appear to apply the more lenient test used by many courts to assess an FTC preliminary injunction request.[28] That more lenient test, employed by the Heinz court (a case cited in the FTC brief,)[29] requires merely that "the FTC has raised questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals."[30] While Judge Jones cited to a number of cases on this point, (including a different case that used the "serious, substantial, difficult and doubtful" standard) he did not use that language in his opinion, and instead seemed to require the FTC to meet a significantly higher standard, holding simply that "a district court must determine the likelihood that the FTC will ultimately succeed on the merits."[31]

This is a potentially important issue, and if indeed the lower court held the FTC to an unnecessarily high standard it would offer the appellate court another avenue to overturn the district court, but the FTC did not emphasize it in its brief. It cites Heinz as support for the standard that it believes should be applied, but it does not quote the "serious, substantial, difficult and doubtful" language used by the Heinz court and the FTC never actually states in its appeal that the court here applied the wrong standard. It is possible that this somewhat elliptical approach to advocacy is an effort to avoid the on-going controversy surrounding the issue of the proper injunction standard for the FTC.[32] Whatever the reason, it is difficult to predict how the Third Circuit may approach the issue, given that it is not entirely clear what standard the district court applied and that the FTC never squarely raised the issue.

## III. CONCLUSION

The FTC's appeal from Judge Jones' decision denying a preliminary injunction asserted that the district court committed a number of legal errors covering a range of issues, but the core of the FTC appellate argument and the likely key to the Third Circuit's decision is the issue of

[28] *Penn State Hershey*, 2016 WL 2622372, at *2.
[29] FTC Brief at 32 (citing *FTC v. H.J. Heinz Co.*, 246 F.3d 708 (D.C. Cir. 2001)).
[30] *Heinz*, 246 F.3d at 714 (internal quotations and citations omitted); see also *F.T.C. v. Promedica Health System, Inc.*, 2011 WL 1219281 (N.D. Ohio March 29, 2011), at *53 (utilizing same standard).
[31] *Penn State Hershey*, 2016 WL 2622372, at *2 (citing *FTC v. United Health, Inc.*, 938 F.2d 1206, 1217 (11th Cir. 1991).
[32] See, e.g. Standard Merger and Acquisition Reviews Through Equal Rules Act of 2015, H.R. 2745, 114th Congress (2015) (The SMARTER Act of 2015) (passed the U.S. House of Representatives on March 23, 2016) (legislation to make the FTC preliminary injunction standard consistent with the traditional preliminary injunction standard used by the DOJ in merger cases).

how to properly define the relevant geographic market. Given the way the issue has been framed, if the Third Circuit decides the issue as a matter of law – rather than simply as a factual dispute over how Judge Jones weighed the record evidence in the case – it may well lead to an important decision on the proper method to define the geographic market in hospital merger cases that will have implications in future cases. An appellate ruling in the FTC's favor would further cement the agency's success in shifting the legal terrain for hospital mergers. A loss, however, would reverse years of FTC success, force the FTC to reconsider its approach, and potentially make it substantially easier for hospital operators to combine in the future.