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Expectations for Healthcare Mergers During the Pandemic

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Trends in merger investigations related to the current COVID-19-induced downturn may be too new to fully assess, yet it seems likely that antitrust economists and counsel will reprise several of the challenges faced during the Great Recession. Looking to that period for guidance, this article considers likely developments in healthcare mergers as well as challenges particular to the current pandemic.

Potential Increase in M&A Activity Involving Distressed Firms

Given the toll of the COVID-19 pandemic on economic activity, observers have speculated that the increased number of struggling firms may lead to an increase in merger activity invoking the failing firm defense.[2] Transactions relying on the failing firm defense require the merging parties to demonstrate that the allegedly failing firm:

- Is in danger of failing to meet its imminent financial obligations
- Is unable to reorganize through bankruptcy
- Has made unsuccessful good-faith attempts to find alternative purchasers.

However, the failing firm defense has a notoriously high burden of proof and the DOJ and FTC (collectively "the agencies") have stated that they will continue to hold failing firm defenses to a high standard throughout the pandemic.[3]

Although the pandemic has increased the likelihood of failing firms across industries, the healthcare sector may be particularly prone to such struggles, despite the monetary relief offered by the CARES Act and the Paycheck Protection Program and Health Care Enhancement Act.[4] Between Q4 2019 and Q1 2020, when U.S. gross domestic product declined by 5.0 percent, healthcare expenditures declined by 17.3 percent.[5] This outsized decline in healthcare expenditures coincided with substantial reductions in patient volumes across healthcare providers: inpatient admissions declined by 30 percent, emergency room visits fell by 40 percent, and outpatient surgery visits dropped by over 70 percent.[6]

During the initial stages of the pandemic, hospitals experienced a decline in revenue of over $1.4 billion *per day* between March 1, 2020, and April 15, 2020, and laid off 135,000 employees over a similar time period.[7] Beyond hospitals, providers across the healthcare sector are suffering, as evidenced by the reduction of 1.4 million jobs in the healthcare industry between March and April 2020.[8] An effect on insurers may follow the effect on providers, despite the reduction in costs due to reductions in health claims, as layoffs lead to reduced premium revenues and drive individuals to health plans that are less profitable for insurers. Ratings agencies have issued negative or stable outlooks for the industry.9 [9]

One important driver of the reductions in volume and revenue is the many state-imposed delays in elective procedures,[10] which tend to be more profitable services for healthcare providers. Elective procedures account for, on average, over one-third of hospital admission spending.[11] In rural areas, where there may be a single hospital serving an entire community, the ongoing pandemic has only exacerbated the existing financial strain. Prior to the pandemic, 25 percent of rural hospitals were at "high risk of closing" (44 percent of rural hospitals were unprofitable); the reduction in outpatient services — which comprise 76 percent of total hospital revenues — may increase their financial vulnerability.[12] Although hospitals and other healthcare providers in these communities may be seen as having market power, cash infusions through mergers with other health systems may be required to ensure their future longevity.

Even in light of the economic downturn, however, healthcare mergers involving a financially distressed firm will not skirt the agencies' review simply by invoking the failing firm defense.[13] Expert analysis will likely be necessary to analyze the impact of the pandemic on the financial viability of the merging parties, whether the struggling firm could successfully reorganize, and whether there were good-faith attempts to find alternative purchasers in light of the current economic conditions. Expert analysis can help attorneys answer questions such as: What is the appropriate way to project provider or insurer financials, given the effect of the pandemic on employment and, as a likely result, Medicaid enrollment? Are revenues from elective procedures lost or simply deferred? What is the relevant market for potentially failing assets and how might it change given the rapidly evolving economic conditions?

Potential Increase in Canceled Mergers

The Great Recession saw a dramatic reduction in M&A activity, including a record number of merger cancellations in 2008.[14] Initial evidence suggests that a similar trend may play out in the COVID-19 crisis. For example, Xerox recently dropped its $34 billion bid for HP, citing the pandemic, and Bed Bath & Beyond commenced litigation against 1-800-Flowers over crisis-related delays in the sale of one of the home goods retailer's divisions.[15] Acquisitions in the healthcare sector are also being impacted: Beaumont Health delayed its acquisition of Summa Health, UMass Memorial Health Care's acquisition of Harrington HealthCare was pushed back, and Jefferson Health called off its purchase of the Fox Chase Cancer Center.[16] In 2019, there were ninety-two announced transactions among hospitals and health systems, and some of these transactions may face cancellations or delays given the hardships that healthcare providers are experiencing.[17]

Matters relating to canceled or delayed mergers — such as breach of contract, reverse termination fee disputes, and alleged violations of "best efforts" obligations — may require expert analysis to evaluate the economic, financial, and regulatory risks of the merger. Experts may also evaluate how conduct by the parties following the merger agreement may have introduced new risks to the merger that were not present as of the agreement — an analysis that may be particularly relevant for healthcare mergers in light of the ongoing pandemic. These analyses can help inform courts as to whether material adverse changes in business conditions constitute sufficient grounds for waiving termination fees or whether the conduct of one party warrants assigning damages.

Potential for Heightened Scrutiny of Competitive Effects

Another Great Recession trend that some observers predict will reoccur during the COVID-19 pandemic is a decline in merger activity. Notably, however, despite the substantial decline in merger activity following the Great Recession, the absolute number of second requests and merger challenges remained stable relative to 2008.[18]

To the extent that the number of second requests and merger challenges during this downturn remains stable, or falls by less than the anticipated decline in merger activity, those mergers that are pursued may be seen as facing increased challenges. Observers have speculated, for example, that the current economic downturn may accelerate a pre-crisis trend towards heightened scrutiny of mergers not traditionally viewed as problematic, including vertical mergers, mergers potentially building monopsony power, and consummated and potential acquisitions that fall below the HSR threshold.[19]

Part of this may be due to difficulties in predicting whether current market competition is a sufficient proxy for future competition, given the evolving economic environment. The complexity of healthcare markets, furthermore, requires a nuanced analysis of competitive effects in these historically less scrutinized mergers, given the defining features of the industry, including moral hazard, information asymmetries, complex reimbursement schemes, price negotiations, and potential applications of two-sided market theories.

For example, increased scrutiny of vertical healthcare mergers may mean that the agencies' review of insurer/provider or provider/device manufacturer mergers will involve analyses related to foreclosure and raising rivals' costs, as discussed in the recently released Draft Vertical Merger Guidelines.[20] Effective merger analysis in the healthcare context will need to balance potential anticompetitive changes in patient choice resulting from changes in physician referral patterns, pharmacy steering patterns, or coverage policies, with potential improvements in care coordination, quality, and costs. In addition, vertical mergers in healthcare, or mergers of complements more broadly, could strengthen incentives to reduce total healthcare costs. For example, the merging parties may be better suited to promote preventive care or facilitate information sharing to improve formularies and design stronger incentives for medication adherence.

Vertical merger analyses may also need to more broadly incorporate trade-offs between higher prices and supply chain stability. As the healthcare system regroups from the immediate effects of the pandemic and reassesses its preparedness levels for future health crises, firms are likely to reconsider the riskiness of a supply chain that is heavily dependent on foreign firms. As the number of COVID-19 infections rose in early 2020, the United States encountered increasing difficulties in importing sufficient quantities of key equipment (ventilators, personal protective equipment, etc.) from countries such as China, which produces over half of the world's face masks.[21]

Reducing the risk of future shortages may mean on-shoring production facilities and distributions systems or expanding existing capacity through, for example, vertical integrations with medical supply manufacturers.[22] Integrating with domestic producers — whose costs of production are higher — may lead to increased healthcare prices. At the same time, a refocus on domestic producers could mean the upstream market for healthcare equipment shrinks from a global market to a national one, and could lead to higher barriers to entry (as U.S. standards may be more stringent). Such concerns may increase fears of foreclosure and other anticompetitive effects. Expert analysis of these vertical integrations may be necessary to disentangle indicators of potential anticompetitive behavior from higher prices due to anticipated increases in input costs.

Mergers allegedly building monopsony power in input markets, such as mergers between insurers (as purchasers of healthcare services) or healthcare providers (as purchasers of labor), could also draw enhanced interest.[23] Evaluating the effects of monopsony power in healthcare, too, raises important questions and considerations such as whether the alleged monopsony power is sufficient to generate anticompetitive conduct; the types of efficiencies that may be created through the increase in bargaining power; and whether the merging parties have an incentive to pass cost savings through to consumers.

The DOJ and FTC recently issued a joint statement on COVID-19 and protecting competition in labor markets for frontline workers. The agencies recognized the necessity of increased cooperation among private businesses and other entities, but also the potential for anticompetitive practices.[24] Assessing the likelihood and degree of anticompetitive effects against potential efficiencies requires a deep understanding of the mechanics of the healthcare sector.

Finally, the pandemic may reinvigorate reviews of consummated mergers (or proposed mergers) that had been (or are) too small to trigger HSR filing requirements, but today may attract greater antitrust scrutiny. Such investigations are already occurring in the healthcare, pharmaceuticals, and technology sectors,[25] but may expand more broadly in the healthcare sector given the pandemic. For example, by the time the FTC challenged prosthetics manufacturer Otto Bock's 2017 acquisition of rival Freedom Innovations, which was not subject to HSR premerger notification requirements, the deal had already been completed.[26] More recently, medical device manufacturer Covidien's 2012 purchase of Newport Medical Instruments, a ventilator manufacturer, was characterized as a "killer acquisition" that may have "contributed to the current shortage of ventilators."[27] Days later, FTC Commissioner Slaughter called for a retrospective review of the acquisition.[28]

Evaluating the merits of a challenge to a consummated healthcare merger could involve economic analyses of market structure, market power, competition, and entry, grounded in the facts and realities of the complex relationships of the healthcare sector. How closely did the two firms compete? How likely were patients — whose decisions may be driven by physician recommendations and insurance coverage — to substitute between products? For hospital mergers, when is it appropriate to define product markets as a cluster of inpatient services, versus singling out a single service, as the FTC did in its challenge to ProMedica Health System's consummated acquisition of St. Luke's Hospital?[29] Understanding the economics of the continuously evolving healthcare sector and the nature of relationships between market participants in the healthcare space can help to assess the potential of a future challenge to a non-reportable merger.

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[3] Bryan Koenig, "Mergers during COVID-19 Create New 'Failing Firm' Paradigm," *Law360*, May 11, 2020; Ian Conner, "On 'Failing' Firms — and Miraculous Recoveries," U.S. Federal Trade Commission, May 27, 2020.

[4] "CARES Act Provider Relief Fund," U.S. Department of Health & Human Services, https://www.hhs.gov/coronavirus/cares-act-provider-relief-fund/index.html; Kellie Moss, "The Paycheck Protection Program and Health Care Enhancement Act: Summary of Key Health Provisions," Kaiser Family Foundation, May 1, 2020.

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[6] The decline in provider volume is measured as the change between January 2020 and April 2020. See "Hospital Volumes Hit Unprecedented Lows," Crowe, May 2020.

[7] Note that the 135,000 employees statistic is based on employment changes between March 2020 and April 2020. See "Hospital Volumes Hit Unprecedented Lows," Crowe, May 2020;

[8] "Current Employment Statistics – CES (National): Employment and Earnings Table B-1a," U.S. Bureau of Labor Statistics, April 2020, https://www.bls.gov/web/empsit/ceseeb1a.htm.

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[10] "Factsheet: State Action Related to Delay and Resumption of 'Elective' Procedures during COVID-19 Pandemic," American Medical Association, May 2, 2020.

[11] Numbers are based on spending by large employer plans for non-elderly enrollees. Cynthia Cox et al., "How Health Costs Might Change with COVID-19," Peterson-KFF Health System Tracker, April 15, 2020.

[12] "The Rural Health Safety Net Under Pressure: Understanding the Potential Impact of COVID-19," The Chartis Group, April 2020; "One-in-Four U.S. Rural Hospitals at High Financial Risk of Closing as Patients Leave Communities for Care," Guidehouse, April 8, 2020.

[13] Ian Conner, "On 'Failing' Firms — and Miraculous Recoveries," U.S. Federal Trade Commission, May 27, 2020.

[14] Jessica Hall, "Global M&A Falls in 2008," *Reuters*, December 22, 2008.

[15] SoftBank has also put its purchase of additional WeWork shares on hold and Boeing suppliers Hexcel and Woodward have called off their merger, citing "unprecedented challenges" in this environment. Richard Harroch, David Lipkin & Richard Smith, "The Impact of the Coronavirus Crisis on Mergers and Acquisitions," *Forbes*, April 17, 2020.

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[17] "2019 Healthcare M&A in Review," Kaufman Hall, January 2020.

[18] Tim Haney, "A Look Back at Recession's Effect on Merger Challenges," *Law360,* April 23, 2020.

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[20] "Draft Vertical Merger Guidelines," U.S. Department of Justice and Federal Trade Commission, January 10, 2020.

[21] Megan Ranney, Valerie Griffeth & Ashish Jha, "Critical Supply Shortages – The Need for Ventilators and Personal Protective Equipment during the Covid-19 Pandemic," *New England Journal of Medicine*, April 30, 2020; Kate O'Keeffe, Liza Lin & Eva Xiao, "China's Export Restrictions Strand Medical Goods U.S. Needs to Fight Coronavirus, State Department Says," *Wall Street Journal*, April 16, 2020.

[22] For example, Premier Inc. recently announced a new initiative to invest in domestic manufacturers to "ensure a robust and resilient supply chain for essential medical products," and subsequently joined fifteen health systems to acquire a minority stake in Prestige Ameritech, the largest U.S. manufacturer of face masks. See "Premier Inc. Launches New Program to Invest in Domestic and Diverse Manufacturing Capabilities," Premier Inc., May 19, 2020; Fred Pennic, "Premier & 15 Health Systems Acquires Minority Stake in PPE Company to Address Shortage from COVID-19," *HIT Consultant*, May 27, 2020.

[23] Note that the DOJ held a public workshop on competition in labor markets in late 2019, which included the topic of "labor monopsony in merger enforcement." See "Public Workshop on Competition in Labor Markets," U.S. Department of Justice, November 18, 2019.

[24] "Justice Department and Federal Trade Commission Jointly Issue Statement on COVID-19 and Competition in U.S. Labor Markets," U.S. Department of Justice, April 13, 2020.

[25] Cecilia Kang & David McCabe, "F.T.C. Broadens Review of Tech Giants, Homing In on Their Deals," *New York Times*, February 11, 2020.

[26] Matthew Perlman, "FTC Orders Prosthetic Maker to Unwind Merger," *Law360*, November 6, 2019.

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[29] Complaint Counsel's Post-Trial Brief in the Matter of Pro-Medica Health System Inc., Docket No. 9346, September 20, 2011, pp. 18–19.