CLIENT ALERT

FTC ALJ Order Hospital Merger Undone

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On October 20, 2005, Federal Trade Commission Administrative Law Judge Stephen McGuire determined that the $200 million merger of Highland Park Hospital ("HPH") with Evanston and Glenbrook Hospitals, resulting in the formation of Evanston Northwestern Healthcare ("ENH"), substantially reduced competition for "general acute care inpatient services sold to managed care organizations" in a suburban area north of Chicago, and therefore violated Section 7 of the Clayton Act. As a result, ENH has been ordered to divest itself of HPH by April 18, 2006. On October 26, 2005, ENH filed notice of its intent to appeal the decision to the full Federal Trade Commission ("FTC"). *Evanston Northwestern Healthcare Corporation*, FTC Dkt. 9315.

ENH purchased HPH on January 1, 2000, following a string of unsuccessful courtroom challenges to hospital mergers by federal antitrust enforcers. Unlike those, which were prospective challenges to proposed hospital mergers, the FTC challenged ENH's merger after it occurred and after effects of the merger could be analyzed in an FTC administrative proceeding. The FTC filed a complaint in February, 2004, alleging 1) substantial lessening of competition in a defined market in violation of the Clayton Act; 2) substantial lessening of competition in an undefined market, in violation of the Clayton Act; and 3) price fixing by ENH Medical Group, a group of employed and independent physicians associated with HPH and ENH. The price fixing count was settled and dismissed prior to trial.

ALJ McGuire first relied on precedent to conclude that "general acute care inpatient services", other than quaternary services, constituted the relevant product market. Outpatient hospital services were excluded as non-substitutable for such inpatient hospital services.

ALJ McGuire determined that neither the FTC's proposal nor ENH's proposal for a defined geographic market were appropriate, but rather concluded that a suburban area containing seven total hospitals, including ENH's three, constituted the relevant geographic market. ALJ McGuire specifically concluded that post-merger evidence of health plans' "inability to selectively contract or steer patients to more distant hospitals to avoid ENH' s price increases is powerful evidence that a local market for hospital services exists in the geographic market and that patients want a local hospital in their managed care plan." Therefore, ALJ McGuire determined the "key issue" in defining the geographic market was "identifying which hospitals [are necessary for health plans] to have in their hospital networks in order to establish viable, competitive networks."

ALJ McGuire concluded that 1) patient flow data is an inappropriate basis for identifying which hospitals are necessary for the viability and competitiveness of health plans' networks; and 2) the so-called Elzinga-Hogarty analysis, which measures percentages of such inflow and outflow, is also an inappropriate factor. To construct the relevant geographic market, ALJ McGuire thus examined evidence of market participants' views of hospital competition, geographic proximity, patient travel times to hospitals, and physicians' admitting practices.

After determining the relevant product and geographic markets, ALJ McGuire concluded that ENH enjoyed an approximate 40% share of the seven-hospital geographic market, substantially higher than the 30% share used as a rule-of-thumb benchmark of market power. After finding that ENH had market power in the relevant markets, ALJ McGuire found that "[c]ontemporaneous

and post-acquisition evidence establishes that ENH exercised its enhanced post-merger market power to obtain price increases significantly above its premerger prices and substantially larger than price increases obtained by other comparison hospitals."

Much of the evidence cited by ALJ McGuire included ENH's own internal documents and testimony, which reflected an intent to gain market share and raise prices. This evidence, in conjunction with evidence that he found ruled out certain other factors as causative of the price increases, led ALJ McGuire to determine that ENH's exercise of market power actually caused the price increases.

Specifically ruled out as a factor inducing the price increases was ENH's claim that the quality of care provided at HPH had improved. ALJ McGuire indicated that improvements in quality of care may generally be a pro-competitive justification for certain conduct, but specifically found that ENH's improvements to the quality of care provided at HPH were 1) not merger-specific, i.e., they could have occurred absent the merger; 2) unrelated to the prices that ENH charged for services at its other two hospitals; and 3) insufficient to outweigh the anti-competitive nature of ENH's conduct.

Of other interest, ALJ McGuire concluded that hospitals compete with each other on two "stages". First, they compete with each other to be included in managed care organizations' provider networks – and do so primarily on the basis of price. Second, hospitals compete with each other to attract patients – and do so primarily *not* on the basis of price, as patients are insulated from price constraints, but rather on the basis of non-price factors, such as quality of care and amenities.

The ALJ's emphasis on ENH"s ability to demand higher prices from health plans as evidence not only of market power but also of the appropriate geographic market will, if upheld, provide a powerful tool to antitrust enforcers in hospital merger matters. The ruling is an instructive follow-on to prior successful FTC litigation involving office supply stores where evidence of actual price differences were found to be powerful evidence on market and competitive effects issues, irrespective of defense arguments about competitive constraints posed by alternate suppliers. For now, though, the ruling is subject to appeal, first to the FTC itself, and then perhaps to an appellate court.

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