

CLIENT ALERT

Know Your SSNIP: FTC Prevails in Hospital Merger Appeals

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Two important decisions from the Third and Seventh Circuits recently ended a short-lived losing streak for the Federal Trade Commission (FTC) in hospital merger cases, which had been seen as potentially crippling after a long string of court victories going back over a decade.

Most recently, on October 31, 2016, a three-judge panel of the Seventh Circuit unanimously reversed a district court ruling against the FTC's request for a preliminary injunction involving the merger of two Chicago-area hospitals, Advocate Health Care Network and NorthShore University HealthSystem. The Seventh Circuit focused on the district court's flawed geographic market analysis, calling it "clearly erroneous," and endorsed the FTC's analytical framework for evaluating market definition in hospital mergers. On September 27, 2016, the Third Circuit reversed for the same reason.

Advocate-NorthShore

In December 2015, the FTC and the State of Illinois filed suit to block the \$2.2 billion hospital merger between Advocate and NorthShore—a deal that would have created the eleventh largest hospital system in the country—arguing that the combination would lead to higher health care costs and decreased quality for general acute care services, which are sold to commercial health plans and their members. To prove its case, the FTC relied primarily on its economic expert to describe the likely effects that would result from the merger. The FTC used the "hypothetical monopolist test" to confirm the appropriate geographic market.

The hypothetical monopolist test, as its name suggests, asks whether a hypothetical monopolist could impose a small but significant non-transitory increase in price (SSNIP) in the proposed market post-merger. Antitrust enforcers generally interpret this to mean whether a hypothetical monopolist would be able to successfully impose a 5-10 percent price increase without causing health plans to drop the merged hospitals from their networks. If so, the geographic market is properly defined. The purpose of defining a geographic market is to understand the competitive effect of the transaction on customers, and in hospital merger cases, typically commercial insurance companies (payers) are considered the most relevant customers.

In determining the relevant geographic market, the FTC excluded "destination hospitals" or academic hospitals located outside Northern Chicago that drew patients from across the Chicago area, including from the Northern Chicago suburbs. The FTC excluded these hospitals because they would not be viewed as viable substitutes by commercial payers putting together a provider network for Northern Chicago patients who often demand local and convenient hospital options.

In a break with the prevailing view of hospital merger economics, namely, that insurer willingness to pay is a more accurate indicator of the relevant geographic market than patient outflow data, the district court ruled against the FTC's motion for a preliminary injunction. The lower court took particular issue with exclusion of the destination hospitals, reasoning that the FTC's approach "assume[d] the answer to the very question the geographic market exercise is designed to elicit." The lower court also

reasoned that diversion ratios, demonstrating that 48% of patients within the alleged geographic market would stay within the market if their first choice was not available, was further proof that the FTC's market definition was flawed.

The Court of Appeals disagreed with the lower court's departure. The Seventh Circuit ruled that the district court's "central error" was that it misunderstood the hypothetical monopolist test by mistaking an iterative test for logical circularity. It cited three specific errors committed by the district court.

First, the district court incorrectly found that the FTC lacked a basis for distinguishing local hospitals from academic medical centers where the demand for destination hospitals differed from demand for general acute care hospitals, like the parties' hospitals, which drew patients from much smaller geographic areas. Second, the district court erroneously determined that the FTC's evidence about patient preferences for local hospitals was "equivocal" where strong evidence showed that patients, in fact, seek hospital care close to their own communities. Finally, the Seventh Circuit found that the district court's analysis fell prey to the "silent majority fallacy." In other words, just because some patients travel a far distance to obtain care does not mean the merging parties have no market power over payers for those patients who would not leave the relevant geography. As the Seventh Circuit explained, the decision placed too much emphasis on patients (for example, by highlighting the diversion ratios) instead of payers as the primary customers over which the merging parties could exercise market power. For these reasons, the Seventh Circuit reversed the district court's decision and remanded the case for further proceedings. The merging parties have not yet announced whether they will continue to pursue the merger.

Hershey-Pinnacle

Advocate-NorthShore follows on the heels of another closely watched merger of two Pennsylvania hospitals that was ultimately abandoned after the FTC successfully secured a preliminary injunction. There, the FTC filed suit against the two hospitals out of concern that the merger would create a dominant provider of general acute care in the Harrisburg, Pennsylvania area and would likely lead to increased health care costs and reduced quality of care.

As in Advocate, the Third Circuit overturned the district court's decision partly on the basis of incorrect application of the hypothetical monopolist test. The Court found that the lack of a proper hypothetical monopolist test- and geographic market- analyses rendered the district court's findings "economically unsound and not reflective of the commercial reality of the healthcare market."

In particular, the district court relied on patient flow data, which, like the Seventh Circuit, the Third Circuit said is "not consistent with the hypothetical monopolist test" and particularly unhelpful in hospital merger cases because it does not "properly account for the likely response of insurers in the face of a SSNIP"—the silent majority fallacy. As a result, the Third Circuit reversed the district court's opinion and directed the lower court to enter a preliminary injunction. The merger has since been abandoned.

Key Takeaways

After two successive losses in different district courts, it appeared as though the FTC's long standing approach of using the hypothetical monopolist test to define a relevant geographic market in hospital merger cases was in jeopardy. Now, with two successive appellate wins, the FTC's approach is not only vindicated but also judicially affirmed. Looking ahead, one can expect continued use of the hypothetical monopolist test by antitrust enforcers as a way to define a relevant geographic market and

thereby assess competitive harm in hospital merger cases. More fundamentally, the FTC will likely continue to prioritize health care cases and hospital merger challenges in particular, so we expect close scrutiny of any transaction among significant competitors.

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