August 16, 2007

Federal Trade Commission Finally Wins a Hospital Merger Challenge

The Federal Trade Commission (FTC) recently prevailed in a challenge to a hospital merger – the first successful hospital merger challenge since 1990. The FTC ruled on August 6, 2007, that Evanston Northwestern Healthcare Corporation's (ENH) acquisition of Highland Park Hospital (Highland Park) was anticompetitive and violated Section 7 of the Clayton Act.[1] In reversing an 18-year series of decisions favoring hospitals in hospital merger cases, the decision is significant for several reasons:

1. The FTC brought this challenge as a Part 3 administrative proceeding in Washington, D.C. – not an injunction action in federal court where the hospitals were located.

2. The case was an unusual retrospective look at a merger that had been consummated in 2000, and the FTC had an extensive record of empirical pricing data to determine the effect of the merger.

3. The FTC's market definition rejected relying only on the standard Elzinga-Hogarty test that focuses on patient travel patterns to determine potential market power in the relevant geographic market, but, instead, emphasized the substantial price increases charged by the hospitals after the merger to demonstrate the merger substantially reduced competition.

4. The FTC's remedy was not the usual structural remedy of divestiture, but was an injunction to prevent coordinated contract negotiations between ENH and Highland Park.

Case Background

On January 1, 2000, ENH and Highland Park merged after having completed the normal Pre-Merger Notification under the Hart-Scott-Rodino Act (HSR Act). Two years later, the FTC announced it was going to review several consummated hospital mergers to determine if the mergers had subsequently resulted in anticompetitive price increases. This review was prompted by the FTC's desire to understand better the impact of hospital mergers, particularly in light of the seven straight unsuccessful challenges in court since 1990 by both the FTC and the Justice Department Antitrust Division. As a result of this retrospective review the FTC filed its challenge in 2004 to the ENH/Highland Park merger. The FTC's complaint, which was the only case filed as a result of the FTC's retrospective

1 *In the Matter of Evanston Northwestern Healthcare Group and ENH Medical Group, Inc.*, File No. 011 0234 (issued August 6, 2007) available at http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf.

review, alleged that, following the acquisition, ENH raised the prices charged to health insurers far above price increases of other comparable hospitals. (The price increases were in some cases 34 to 113 percent higher than other Chicago-area hospitals.)

The ALJ Decision: October 2005

By conducting a retrospective Part 3 administrative trial, the FTC avoided going to federal court in the hospitals' jurisdiction, and the FTC was able to develop a fulsome factual record over the eight-week trial that included over 1,600 exhibits and 42 witnesses. Thus, the factual record was much more complete than would have been possible in a typical preliminary injunction hearing in federal court, where the FTC would have attempted to show the potential market power resulting from the merger.

The FTC staff alleged that the relevant geographic market consisted of the triangular area bordered by the three ENH hospitals along the shore of Lake Michigan in the northern suburbs of Chicago. The staff alleged the relevant product market was general acute care inpatient services sold by hospitals to private health insurance companies. The staff relied heavily on econometric evidence showing that the hospitals had dramatically increased prices to payors after the merger, a fact that even the hospitals' economic expert acknowledged. The staff also focused on internal memoranda and announcements by hospital executives about the purpose of the merger and the effect of the merger in achieving significant price increases.

Nearly five years after the consummation of the merger, Chief FTC ALJ Stephen J. McGuire ruled in favor of the FTC in October 2005 and ordered ENH's full divestiture of Highland Park within 180 days. Judge McGuire did not agree with the staff's narrow geographic market, but he concluded ENH's acquisition of Highland Park resulted in "substantially lessened competition" and higher prices for insurers and health care consumers for general acute care inpatient services sold to managed care organizations (MCOs) in a cluster of seven hospitals, including the three ENH hospitals, in Chicago's North Shore area.

In reviewing this evidence, the ALJ rejected ENH's alternative, benign explanations for the price increases and arguments about the merger's procompetitive benefits and rejected ENH's argument that the relevant geographic market should have included at least six other Chicago-area hospitals.

The Commission Opinion: August 2007

More than a year after oral argument in this case, the FTC affirmed the ALJ's liability decision by a 5-0 vote. The FTC ruled that the evidence "demonstrates that the transaction enabled the merged firm to exercise market power and that the resulting anticompetitive effects were not offset by merger-specific efficiencies."

The FTC based its holding in part on the econometric analysis performed by both parties. After a lengthy discussion of the econometric methods, results and implications, the FTC stated that the economic data demonstrated unequivocally that post-merger prices to MCOs had risen substantially more than other Chicago-area hospitals' prices (e.g., prices were higher to Aetna by 30 to73 percent; United 34 to 113 percent; BCBS 1 to 16 percent; Great West 13 to 27 percent), and that it was highly unlikely that these increases resulted from causes other than the merged entity's ability to exercise and leverage its market power. Notably, the FTC agreed with the staff that the product market was negotiation with MCOs to provide inpatient acute care hospital services, and that the market excluded out-patient services. The FTC also agreed with the staff that the relevant geographic market could be limited to the area bounded by the three ENH hospitals and rejected the ALJ's broader market area of seven hospitals. Significantly, the FTC noted that the traditional Elzinga-Hogarty test for determining relevant geographic markets by patient flow was inappropriate in a service industry where differentiated products or services are sold. The Elzinga-Hogarty test had previously been the death knell for the FTC in challenging hospital mergers because the test resulted in courts defining very broad hospital markets in which the mergers had an insignificant impact.

The FTC's opinion also emphasized the documentary and testimonial evidence of ENH management. For example, post-merger documents showed that ENH attributed the price increases in large part to enhanced bargaining leverage with payors made possible by the merger. In fact, minutes from an ENH board meeting held less than one year after the merger reflected that "some $24 million of revenue enhancements" were achieved as a result of MCO renegotiations. An ENH executive observed that "none of this could have been achieved by either Evanston or Highland Park alone." ENH's stated pre-merger objectives were also emphasized by the FTC, based on documentary evidence involving ENH and its consultants. ENH's consultants wrote that the "merger provides the opportunity to reduce costs ... and negotiate contracts with payors from a stronger position." The FTC's reliance on these statements, taken in conjunction with the use of similar pre-merger statements in the pending Whole Foods-Wild Oats merger challenge,[2] indicates the FTC's continued willingness to utilize documents, especially emails, revealing merging parties' views of the merger and the market as evidence of actual or potential competitive harm.

The FTC rejected ENH's justifications for the price increases, such as the natural increase of hospital costs over time, improvements in quality leading to increased demand, and that ENH was charging below-market prices prior to the merger. In large measure, the FTC questioned the veracity of such alternate explanations, focusing on the internal statements by ENH's management. The FTC concluded, based on the economic data associated with the alternative explanations, that even if ENH's more conservative analysis of 9 to 10 percent price increases was to be believed, the increases were still significant enough to be anticompetitive. The FTC also rejected the arguments or defenses that Highland Park was a "weakened company" financially, or that the nonprofit status of the hospitals lessened the potential for anticompetitive harm.

In fashioning a remedy, however, the FTC disagreed with the ALJ that full divestiture was needed. While noting that divestiture is the normal remedy in a merger challenge under Section 7 of the Clayton Act, the FTC acknowledged the unique facts of this retrospective challenge and the "high costs inherent in the separation of hospitals that have functioned as a merged entity for seven years." Rather than affirm a remedy that would sacrifice efficiencies now created by the merged firms, (primarily the development of a cardiac surgery department at Highland Park and the implementation at Highland Park of a state-of-the art medical record computer system) the FTC ordered ENH to establish separate and independent contract-negotiating teams in order to allow MCOs to negotiate

2 *Federal Trade Commission v. Whole Foods Market, Inc., and Wild Oats Market, Inc.*, FTC File No. 071 0114 available at http://www.ftc.gov/os/caselist/0710114/0710114.shtm.

separately with Highland Park and Evanston. The FTC's Order gives ENH 30 days to submit a proposal for implementing the remedy.

Although the FTC's decision may still be appealed to a federal appeals court, the ruling is significant as a rare government merger victory in the hospital industry. On the other hand, the proposed remedy may be very cumbersome to implement, and it is not too dissimilar from the alternative remedy proposed by ENH in its appeal of the ALJ decision. Thus, the FTC decision can be viewed as a partial victory for ENH – although an expensive victory, given that ENH reportedly paid over $30 million in legal fees.[3]

Conclusion and Implications

Federal antitrust enforcement agencies have experienced a string of setbacks in court over the past 17 years in cases seeking to enjoin hospital mergers before their consummation. If the FTC staff had lost this challenge, then, for all intents and purposes, the government would effectively have ended its review of hospital mergers. Unless ENH reverses this decision on appeal, this decision will reaffirm that the FTC still has an active antitrust enforcement role to play in hospital mergers. The FTC's focus on a very narrow geographic market may have an impact on how it will view other hospital mergers in large urban areas, and it is questionable whether a federal court would agree with such a narrow view of the market. The decision also underscores the danger of merging entities getting "greedy" with significantly large post-merger price increases and with internal and public announcements about being able to achieve price increases.

While this is one of the rare situations where an enforcement agency has challenged a completed merger, it serves as a significant reminder that the agencies can challenge anticompetitive conduct even after HSR review. Although in this case the FTC did not order structural relief by way of a divestiture, the FTC strongly signaled that a divestiture remedy would normally be "preferred" for any Section 7 violations. The full FTC stopped short of holding that there need be no proof of relevant geographical and product markets where the record establishes that the transaction has produced unilateral anticompetitive effects. Nevertheless, that is a position that Commissioners Rosch and Leibowitz would have supported. The case demonstrates that the FTC will conduct a rigorous econometric analysis of mergers where such data is available.

Finally the decision is a practical reminder that merging companies should carefully monitor their creation of pre- and post-merger documents to avoid potentially inadvertent and incorrect descriptions of the transaction's goals, aspects and likely market impact.

3 *Finding Victory in Legal Defeat*, Modern Healthcare, Aug. 13, 2007 at 6.

ALSTON+BIRD LLP

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any one of the following.

Members of Alston & Bird's Antitrust Group

Randall L. Allen
404.881.7196
randall.allen@alston.com

William Barron
212.210.9500
william.barron@alston.com

Debra D. Bernstein
404.881.4476
debra.bernstein@alston.com

Adam J. Biegel
404.881.4692
adam.biegel@alston.com

Teresa T. Bonder
404.881.7369
teresa.bonder@alston.com

Kristine McAlister Brown
404.881.7584
kristy.brown@alston.com

Mark Calloway
704.444.1089
mark.calloway@alston.com

Naeemah Clark
212.210.1266
naeemah.clark@alston.com

Rebecca B. Crawford
404.881.4824
rebecca.crawford@alston.com

Stephanie B. Driggers
404.881.7163
stephanie.driggers@alston.com

Rodney J. Ganske
404.881.4996
rod.ganske@alston.com

Kevin E. Grady
404.881.7164
kevin.grady@alston.com

H. Stephen Harris, Jr.
404.881.7197
steve.harris@alston.com

Sean C. Hyatt
404.881.4968
sean.hyatt@alston.com

William H. Jordan
404.881.7850
bill.jordan@alston.com

Alan Kanzer
212.210.9480
alan.kanzer@alston.com

Michael P. Kenny
404.881.7179
mike.kenny@alston.com

Peter Kontio
404.881.7172
peter.kontio@alston.com

Gregory B. Mauldin
404.881.4823
greg.mauldin@alston.com

Mark A. McCarty
404.881.7861
mark.mccarty@alston.com

Heather Munday
404.881.7932
heather.munday@alston.com

Matthew D. Richardson
404.881.4478
matt.richardson@alston.com

Suzanne Smith
404.881.7959
suzanne.smith@alston.com

Thomas Walker
704.444.1055
thomas.walker@alston.com

Kenneth G. Weigel
202.756.3431
ken.weigel@alston.com

Valarie C. Williams
404.881.7631
valarie.williams@alston.com

Selected Members of Alston & Bird's Health Care Group

Robert C. Lower
404.881.7455
bob.lower@alston.com

Donna P. Bergeson
404.881.7278
donna.bergeson@alston.com

Dawnmarie R. Matlock
404.881.4253
dawnmarie.matlock@alston.com

Michelle A. Williams
404.881.7594
michelle.williams@alston.com

If you would like to receive future Antitrust Advisories electronically, please forward your contact information including e-mail address to ***antitrust.advisory@alston.com****. Be sure to put "****subscribe****" in the subject line.*

ALSTON+BIRD LLP

www.alston.com

ATLANTA
One Atlantic Center
1201 West Peachtree Street
Atlanta, GA 30309-3424
404.881.7000

CHARLOTTE
Bank of America Plaza
101 South Tryon Street
Suite 4000
Charlotte, NC 28280-4000
704.444.1000

NEW YORK
90 Park Avenue
New York, NY 10016-1387
212.210.9400

RESEARCH TRIANGLE
3201 Beechleaf Court
Suite 600
Raleigh, NC 27604-1062
919.862.2200

WASHINGTON, DC
The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300

www.alston.com