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FTC Affirms ALJ's Decision That a Merger by Chicago-Area Hospitals Violated the Antitrust Laws

Action: The full panel of Federal Trade Commission (FTC) Commissioners (the Commission) upheld the earlier decision by an Administrative Law Judge (ALJ), concluding that the merger by Evanston Hospital and Glenbrook Hospital with Highland Park Hospital violated Section 7 of the Clayton Act.

Impact: The decision suggests that the FTC's focus on the retrospective review of mergers and acquisitions will continue. As a result, hospital affiliations are susceptible to retrospective review and/or challenge if the FTC determines, with the benefit of post-acquisition economic data, that an affiliation resulted in a substantial deleterious effect on competition.

Effective Date: Immediately.

On August 6, 2007, the FTC unanimously affirmed an earlier ALJ decision, concluding that the merger by Evanston Hospital and Glenbrook Hospital with Highland Park Hospital substantially lessened competition in violation of Section 7 of the Clayton Act. Although the FTC's decision affirmed the ALJ's ruling, the FTC did not adopt the divestiture remedy ordered by the ALJ and, instead, ordered that the merged hospital system establish separate managed care negotiating teams for the member hospitals.

The *Evanston Northwestern* Merger

In 2000, Evanston Hospital and Glenbrook Hospital merged with Highland Park Hospital and merged the combined entity into Evanston Northwestern Healthcare Corporation (ENH). The total value of the merger was in excess of $200 million.

Almost four years later, however, in February 2004, the FTC staff commenced an antitrust enforcement action, alleging that the merger had substantially lessened competition, and, therefore, caused the price of health care services to rise. Invoking principally Section 7 of the Clayton Act, which prohibits transactions "where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly," the FTC alleged that the merger had substantially lessened competition by aggregating the hospitals' market power resulting in increased prices for health care services.

The ALJ's Decision

Retrospective Challenge/ Post-Acquisition Evidence

The ALJ's decision may be viewed as validating the FTC's shift in focus in the field of hospital mergers from prospectively attempting to prevent mergers to its retroactive review of consummated mergers, a move that was first announced in 2002. After suffering a string of defeats in prospective challenges to hospital mergers, the FTC changed its focus to review consummated mergers, to determine whether: (a) the promised efficiencies had actually come to fruition and (b) consumers ultimately benefited, as the merging parties represented they would.

By focusing on a completed merger, the FTC obtains the benefit of post-acquisition evidence, which arguably allows for a better empirical evaluation of the merger's actual competitive effects. Here, post acquisition evidence played a significant role in the ALJ's ENH decision. Based upon the extensive economic analysis offered by both parties' economist experts and statistical analyses of price increases (which revealed significantly higher rates of increase for ENH than for comparable hospital systems), the ALJ found that "ENH exercised its enhanced post-merger market power to obtain price increases significantly above its premerger prices and substantially larger than the price increases obtained by other comparison hospitals."

In reaching its conclusion, the ALJ analyzed and ultimately rejected each of ENH's proffered explanations for its price increases (again relying on statistical evidence), and also rejected the procompetitive justifications offered by ENH, including quality of care improvements. The ALJ also relied on the Joint Commission's survey data to find that after the merger there had been no overall improvement in the quality of care at the implicated hospitals. In addition, the ALJ also rejected ENH's fairly vague defense that its non-profit status reduced the potential for competitive harm, and cited the fact that ENH managers received larger bonuses and higher pay increases after the merger. Finally, the ALJ was not persuaded by ENH's claim that Highland Park Hospital was a failing entity that would have perished had it not been acquired by ENH.

Geographic Market Analysis

In many of its unsuccessful hospital merger challenges, the FTC's principal problem has been its inability to prove a relevant geographic market. Thus, over the past few years, the FTC has been signaling its intention to move away from traditionally accepted means for determining the appropriate geographic market for a hospital such as patient flow data and the use of the Elzinga-Hogarty test. In an advisory opinion dated April 1, 2003, concerning the acquisition of Slidell Memorial Hospital by Tenet Healthcare Cooperation, the FTC engaged in an analysis of the health plans available in a town where the only two hospitals were proposing a merger. It found that employers were unlikely to select health plans that did not include the two hospitals, and therefore the merged hospitals would have the ability to raise prices after the merger.

The ALJ's decision in the ENH case adopted this reasoning. He concluded that the real question is not competition for patients, but rather, competition to be included in managed care or other health insurance plans. He accepted the FTC's position that "market realities demonstrate that managed care organizations cannot 'practicably' turn outside the ENH geographic triangle for substitute hospitals."

The ALJ also reasoned that patient flow data is unhelpful to the analysis. "[A]lthough patients may use hospitals outside of the geographic market, the evidence demonstrates that, in this market, these outlying hospitals do not constrain [ENH's] pricing and they are not hospitals to which managed care organizations can turn to construct viable hospital networks."

The ALJ defined the geographic market to include an area largely contiguous with the area surrounding the ENH hospitals (a fairly gerrymandered region), and ignored many hospitals in the northern Chicago area, which ENH urged should have been included in the relevant geographic market. The ALJ also found that this geographic hospital market was highly concentrated, and that the merger had significantly increased that concentration.

Anti-Competitive Intent

The ALJ's opinion is littered with references to pre-merger communications suggesting that one of the purposes of the merger was to increase market power in order to obtain the ability to negotiate higher prices from payors. The fact that this (and not efficiency or improvements in the quality of care) appeared to have been the primary driver for the merger undoubtedly affected the ALJ's analysis.

> For example, Highland Park's CEO said to his board:
>
> "there are ways to at least I think push back on the managed care phenomenon and get the rates back where they ought to be if you are a big enough concerted enough entity."

Similarly, the CEOs of Evanston and Highland Park included as a strategic recommendation the objective of strengthening "negotiating positions with managed care through merged entities and one voice."

Post merger actions and comments by ENH management reinforced this view. For example, management characterized the merger as a success based upon "$24 million of revenue enhancements … achieved — mostly via managed care renegotiations." Likewise, ENH's tactics in renegotiating managed care contracts may have caused raised eyebrows, particularly its approach of always selecting the higher reimbursement rate between Evanston and Highland Park when setting rates for the new merged entity.

Divestiture

As a remedy for the violation of Section 7, the ALJ ordered the divestiture of Highland Park hospital. The ALJ noted that the burden rested with ENH to show that some remedy other than divestiture was appropriate and would adequately redress the violation. The ALJ rejected the alternative remedies proposed by ENH, and did not engage in a very deep analysis of the issues associated with undoing the merger.

The Decision and Order by the FTC

After an appeal by ENH, on August 6, 2007, the full panel of the FTC Commissioners unanimously affirmed the ALJ's decision that the ENH merger was an anticompetitive acquisition that substantially lessened competition in violation of Section 7 of the Clayton Act. As was the case with the ALJ's decision, the FTC relied heavily on (1) the statements by hospital executives and consultants about the reasons for the merger, and (2) economic analysis of the price increases by ENH after the merger.

As a preliminary matter, although the Commission agreed with the ALJ that the relevant product market in the case included hospital services sold to managed care organizations, it departed somewhat from the ALJ's approach to defining the geographic market. Specifically, the Commission relied exclusively on post merger pricing evidence and found that, because prices had increased significantly after the merger, a relevant antitrust market had been defined for purposes of antitrust analysis.

Addressing the evidence of anticompetitive intent and effect, the Commission noted that the record "show[ed] that senior officials at Evanston and Highland Park anticipated that the merger would give them greater leverage to raise prices." In addition, the Commission explained that the "merged firm did in fact raise its prices immediately and substantially after completion of the transaction, and that the same senior officials attributed the price increases in part to increased bargaining leverage produced by the merger."

The Commission also found that the "econometric analyses performed by both complaint counsel's and respondent's economists also strongly supported the conclusion that the merger gave the combined entity the ability to raise prices through the exercise of market power." For example, the FTC's economist found that ENH increased its average net price per case for all patients by 30 percent. The Commission explained that the economic analyses "established that there were substantial merger-coincident price increases and ruled out the most likely competitive benign explanations for substantial portions of these increases."

Finally, the Commission rejected ENH's justifications for the price increases. According to the Commission, the record did not support ENH's position that these increases reflected its attempts to correct a multi-year failure by Evanston Hospital's senior officials to charge market rates to many of its customers or an increased demand for Highland Park's Services due to post merger improvements.

While the Commission agreed with the ALJ that ENH's acquisition of Highland Park violated Section 7 of the Clayton Act, it did not agree that a divestiture was warranted as a remedy. Specifically, the Commission noted that the "potentially high costs inherent in the separation of hospitals that have functioned as a merged entity for seven years" warranted injunctive relief, but not divestiture, to restore the lost competition. As a result, the Commission imposed an injunctive order, requiring ENH to establish separate and independent managed care negotiating teams — one for Evanston and Glenbrook Hospitals, and another for Highland Park. According to the Commission, the separate teams would allow managed care organizations to negotiate separately again for those competing hospitals, thus re-injecting competition between them.

In contrast to the complex, lengthy, and expensive process of divesting Highland Park after seven years of integration, the Commission noted that ENH should be able to implement the required modifications to its contract negotiating procedures in a very short time. The Commission ordered ENH to submit a detailed proposal to the FTC for implementing the injunctive relief imposed within 30 calendar days.

ENH may appeal the Commission's final decision to a federal Court of Appeals. Notice of the appeal must be filed within 60 days of the decision.

Lessons From the *Evanston Northwestern* Proceedings

The FTC decision makes it more likely that the FTC's focus on the retrospective review of mergers and acquisitions will continue. Thus, hospitals and hospital systems should bear in mind that an affiliation could be subject to a retrospective review and/or challenge if the FTC determines after the fact that the affiliation resulted in a substantial deleterious effect on competition.

The *Evanston Northwestern* decision highlights the importance of sensitivity to antitrust issues in pre-merger planning. In this respect, the following guidelines should be observed:

- Parties to a merger should be prepared to analyze prospective affiliations based upon the competitive impact on managed care contracting, and not just in terms of patient flow data.
- In any affiliation, the merging parties should focus on transaction efficiencies. Specifically, the parties should accurately articulate how the transaction will benefit consumers. Such benefits may include improvements in quality, the creation of new services and products, or cost savings.
- The combining entities must avoid using words that suggest that the affiliation is motivated by, or will have, anticompetitive effects.
- Care should be taken to avoid gun jumping. Specifically, the merging entities should not coordinate their activities prior to the closing of the merger nor should they exchange competitively sensitive information unless there are good, pro-competitive reasons for doing so.

Finally, as illustrated by the post-merger review in the *Evanston Northwestern* matter, it also will be important for hospitals and hospital systems to monitor transactions after the fact, to ensure that they do not result in price increases that are out of sync with the market and cannot be explained by factors other than enhanced market power. In addition, affiliations should make sure they are delivering on any pro-competitive promises made in justifying the transaction, such as integration efficiencies, quality improvements, and the like.

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