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Scrutiny After the Fact

Hospitals should take care to avoid post-merger challenge from the FTC.

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The Federal Trade Commission is on a campaign to reduce health care costs. One way to rein them in is to challenge consummated hospital mergers that, in the FTC's view, have resulted in dramatic price increases for patients, insurers, employers, and other payers.

Five years after the nonprofit Evanston Northwestern Healthcare Corp. acquired Highland Park Hospital in suburban Chicago, the FTC is seeking to undue the merger through an administrative trial. If the FTC prevails, challenges to consummated hospital mergers could become more common, and future hospital deals could receive more intense scrutiny.

ALLEGING HIGHER PRICES

Evanston Northwestern acquired Highland Park Hospital in January 2000. As a result, the company's Evanston and Glenbrook hospitals, both located in Cook County, Ill., were combined with Highland Park, which was the closest hospital to the north and located in Lake County. As part of the deal, the Highland Park Independent Physician Group was combined with the Evanston Northwestern Healthcare Medical Group.

The combined group thereafter negotiated prices not only for physicians employed by it but also for several hundred independent practitioners previously affiliated with Highland Park but not part of the Evanston medical group.

The FTC's complaint alleges that following the merger, Evanston Northwestern was able to charge significantly higher prices to health insurers, thus leading to higher costs for the purchasers of health insurance and the consumers of hospital services.

The complaint further alleges that the Evanston Northwestern medical group engaged in illegal price fixing among competing physicians and groups since the independent doctors were never financially or clinically integrated with Evanston Northwestern or the Evanston medical group.

In furtherance of this scheme, Evanston Northwestern allegedly has offered hospital and physician services to payers as a package and has threatened to terminate those payers' contracts if they do not agree to the terms. The price-fixing claim is the subject of a proposed consent agreement tendered to the presiding judge on Jan. 18, but, consistent with FTC rules, not yet filed on the public record.

In July 2004, the FTC and the Justice Department issued a report entitled "Improving Health Care: A Dose of Competition." The report leaves little doubt that such post-consummation challenges to mergers are likely to be a continuing feature of the federal antitrust agencies' approach to the health care industry.

In addition to affirming continued scrutiny of hospital mergers by the two agencies, the report states that emphasis will be placed on the proper definition of the relevant geographic market for the hospital's services and that the agencies would continue to use the "hypothetical monopolist" test reflected in their 1992 joint Horizontal Merger Guidelines. That test seeks to determine how many locations at which a hypothetical monopoly supplier could impose a small, but significant and nontransitory, price increase.

With respect to product markets, the July 2004 report notes the agencies' traditional practice of analyzing hospital product markets as a broad array of acute, inpatient medical conditions. It calls for continued examination of whether smaller markets may exist within that cluster, and it even suggests that other product definitions might be warranted.

BEYOND MARKET DEFINITIONS

Not surprisingly, market definitions have been a primary battleground as the Evanston case has proceeded through the pretrial stages. The company's trial brief contends that the

FTC cannot meet its burden of defining and proving the relevant product or geographic markets.

In response, the agency asserts that market definition is only a "tool" used to predict the competitive effects of a proposed merger. Since this case has been brought following the consummation of the merger, the FTC argues that elaborate market definitions are no longer necessary.

The agency also contends that past hospital merger cases improperly defined the relevant product and geographic markets. Indeed, defining relevant product markets has been difficult in the past because of the multiplicity of services provided by hospitals, the difference in medical treatment needs, and third-party coverage. Among other things, the FTC asserts that those cases did not consider adequately the role of managed care in defining geographic markets.

Managed care organizations affect market analysis substantially, for they negotiate prices on behalf of their subscribers across a wide geographic area embracing a multitude of health care providers. A given provider's ability to make price increases stick is therefore more constrained.

That being said, the heart of the FTC's case is the evidence of price increases that were actually imposed following the merger.

Evanston Northwestern contends that evidence of price increases alone is, as a matter of law, insufficient to demonstrate competitive harm. In addition, it argues that those price increases were occasioned by forces other than an increase in market power caused by the merger, including, among other things, measurable improvements in quality of care.

The FTC counters that its expert testimony will confirm that the price increases were a direct consequence of the exercise of enhanced market power. As for the impact of quality improvements on price, the agency argues both that such improvements did not occur and that, even if they did, they would not constitute a cognizable defense as a matter of law.

Odds on the FTC

By bringing this case to an administrative trial, the FTC is reinvigorating its enforcement efforts on hospital consolidation after the two antitrust agencies lost a combined seven consecutive hospital merger cases in the 1990s. In all those cases, the antitrust agencies challenged the hospital mergers before closing.

Particularly in cases involving nonprofit hospitals, federal district judges seemed willing to accept arguments that these mergers would not lead to higher prices because nonprofits do not have the same incentive to increase prices as for-profit hospitals. Whereas the antitrust agencies contended that nonprofit hospitals had a clear incentive to use their acquired market power to increase revenue—so that they could spend more on salaries and other operating expenses—the judges seemed to view nonprofit hospitals as members of the community with charitable goals.

This time around, the odds favor the FTC—for two reasons.

First, the FTC has the home-field advantage by bringing the case before an administrative law judge instead of in federal district court in the defendant's hometown. Just as in sports, this gives the FTC a better chance of victory.

If the administrative law judge rules in favor of the FTC, an appeal of the ruling goes to the full five-member commission. Presumably, the commission, having voted to issue the complaint in the first place, would more than likely affirm a favorable ruling by the judge as long as the decision is properly supported by the facts and the law.

If the agency affirmed, any further appeals would have to be made to a federal circuit court, which would apply a deferential rational basis/substantial evidence standard of review.

Second, the FTC has the benefit of a mountain of actual data and evidence indicating that prices have, in fact, increased significantly since the Evanston Northwestern merger. In the typical merger case, by contrast, the antitrust agencies do not yet have evidence of post-merger conduct, and the presentation of proof inevitably contains a substantial element of prediction.

Given the advantages that the FTC has in bringing the Evanston Northwestern case in front of the administrative law judge, the outcome of this case is extremely important to the agency and to hospital systems around the United States. The case provides the FTC with an opportunity to create strong precedent for challenging consummated hospital deals in the future, as well as pre-consummated hospital deals.

If the FTC prevails in this litigation, it could send a signal to large hospital systems that even consummated mergers and acquisitions, both profit and nonprofit, can face more difficult antitrust challenges.

Post-Merger Scrutiny

Whether or not it wins the Evanston Northwestern case, the FTC will surely continue to be very selective about which future hospital mergers to challenge. To stay off the agency's radar screen, hospital systems should keep in mind the following considerations:

First, a merged hospital system cannot assume that the FTC will not investigate a closed deal. The agency is clearly willing to conduct a post-closing analysis to determine whether an investigation should be opened and a challenge launched. A post-closing attack is more likely if there were no more than three hospital systems in a specific geographic area before the merger. As in the Evanston Northwestern case, the relevant geographic and product markets will remain hot issues for dispute.

Second, the FTC learns about problematic hospital mergers by monitoring local news articles and customer complaints. If post-merger price increases to managed-care payers, traditional third-party insurers, and employers are substantially greater than those in the past, payers will likely complain to the FTC—which could initiate a lengthy and burdensome investigation and possibly a forced divestiture of a hospital. This means that health care providers should be less aggressive in seeking anti-competitive rate increases, and they should enter into competitive negotiations with managed-care payers and employers.

Third, merged hospital systems should significantly integrate their operations and achieve actual efficiencies. The FTC is less likely to break up such entities. In the end, a merger that results in real cost savings and better patient service is its own best legal defense.

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