PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

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No. 16-2365

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FEDERAL TRADE COMMISSION;
COMMONWEALTH OF PENNSYLVANIA,
Appellants

v.

PENN STATE HERSHEY MEDICAL CENTER;
PINNACLE HEALTH SYSTEM

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OPINION

FISHER, *Circuit Judge*.

At issue in this case is the proposed merger of the two largest hospitals in the Harrisburg, Pennsylvania area: Penn State Hershey Medical Center and PinnacleHealth System. The Federal Trade Commission ("FTC") opposes their merger and filed an administrative complaint alleging that it violates Section 7 of the Clayton Act because it is likely to substantially lessen competition. In order to maintain the status quo and prevent the parties from merging before the administrative adjudication could occur, the FTC, joined by the Commonwealth of Pennsylvania, filed suit in the Middle District of Pennsylvania under Section 13(b) of the Federal Trade Commission Act ("FTC Act") and Section 16 of the Clayton Act, which authorize the FTC and the Commonwealth, respectively, to seek a preliminary injunction pending the outcome of the FTC's adjudication on the merits. The District Court denied the FTC and the Commonwealth's motion for a preliminary injunction, holding that they did not properly define the relevant geographic market—a necessary prerequisite to determining whether a proposed combination is sufficiently likely to be anticompetitive as to warrant injunctive relief. For the reasons that follow, we will reverse. We will also remand the case and direct the District Court to enter the preliminary injunction requested by the FTC and the Commonwealth.

I. Background

A. Factual Background

Penn State Hershey Medical Center ("Hershey") is a

District of Pennsylvania. Invoking Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), and Section 16 of the Clayton Act, 15 U.S.C. § 26, the Government sought a preliminary injunction pending resolution of the FTC's administrative adjudication. In its complaint, the Government alleged that the Hospitals' merger would substantially lessen competition in the market for general acute care services sold to commercial insurers in the Harrisburg, Pennsylvania market. Am. Compl. ¶ 4, at 3-4 (Dist. Ct. ECF 101). According to the Government, the combined Hospitals would control 76% of the market in Harrisburg. *See* Gov't Br. 3-4.

The District Court conducted expedited discovery and held five days of evidentiary hearings. During the hearings, the District Court heard testimony from sixteen witnesses and admitted thousands of pages of exhibits into evidence.

Following the hearings, the District Court denied the Government's request for a preliminary injunction on the basis that the Government had failed to meet its burden to properly define the relevant geographic market. Without a properly defined relevant geographic market, violations of the Clayton Act, and under Section 16 of the Clayton Act, 15 U.S.C. § 26, which likewise authorizes the Commonwealth of Pennsylvania to seek a preliminary injunction. We have appellate jurisdiction under 28 U.S.C. §§ 1291 and 1292(a)(1).

III. Standard of Review

We begin with the familiar standard of review. We review the District Court's "findings of fact for clear error, its conclusions of law *de novo*, and the ultimate decision to grant the preliminary injunct

Court." 521 F.2d at 1252. There, the district court purported to apply the correct standard to determine the relevant product market. The standard was a three-part test set out in *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961). Relevant here, the third step of the *Tampa Electric* analysis required the district court to find that "the competition foreclosed by the contract … constitute[d] a substantial share of the relevant market." *Am. Motor Inns*, 521 F.2d at 1250 (quoting *Tampa Elec.*, 365 U.S. at 328). The Supreme Court directed lower courts that, to ascertain whether competition in a substantial share of the market had been foreclosed,

> it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein.

Id. (quoting *Tampa Elec.*, 365 U.S. at 329).

Although the district court in *American Motor Inns* cited to *Tampa Electric* and purported to apply the *Tampa Electric* test, it did not consider the "the probable immediate and future effects which pre-emption of that share of the market might have within the competitive context of that industry, nor did it in any way advert to the relative strength of the parties." *Id.* at 1252 (internal quotation marks omitted). We explained that by failing to consider this factor required by the economic analysis as announced by *Tampa Electric*, the district court applied the incorrect legal standard. And application of an incorrect legal standard is error as a matter of law. *Id.*

Consistent with the teaching of our precedent, where a district court applies an incomplete economic analysis or an erroneous economic theory to those facts that make up the relevant geographic market, it has committed legal error subject to plenary review. This understanding of economic theory as legal analysis also comports with the Supreme

Id.

liability "relatively expansive." *California v. Am. Stores Co.*, 495 U.S. 271, 284 (1990). At this stage, "[t]he FTC is not required to *establish* that the proposed merger would in fact violate section 7 of the Clayton Act." *H.J. Heinz*, 246 F(1990).

its trade area." App. 12 (internal quotation marks omitted) (quoting *Little Rock Cardiology*, 591 F.3d at 598). Second, it "must then determine whether a plaintiff has alleged a data to determine the relevant geographic market resulted in overbroad markets with respect to hospitals. Professor Elzinga himself testified before the FTC that this method "was not an appropriate method to define geographic markets in the hospital sector." *In re Evanston Nw. Healthcare Corp.*, 2007 WL 2286195, at *64 (F.T.C. Aug. 6, 2007).

The Hospitals dispute that the District Court's formulation of the relevant geographic market standard is the Elzinga-Hogarty test. The District Court's opinion does not specifically name or address Elzinga-Hogarty; neither does the Eighth Circuit's opinion in *Little Rock Cardiology*. But *Little Rock Cardiology*'s statement that the market is one in which "'few' patients leave … and 'few' patients enter," 591 F.2d at 598 (alteration in original), is a direct quote from *Rockford Memorial*, 717 F. Supp. at 1267.

In *Rockford Memorial*, the Northern District of Illinois, after observing that, "[i]deally, an area should be delineated where 'few' patients leave an area and 'few' patients enter an area to obtain hospital services," immediately outlined a step-by-step methodology put forward by the defendants' expert "to implement the Elzinga-Hogarty test." *Id.* This methodology proceeded as follows: first, determine the merging hospitals' service area; second, determine the collective service area of all hospitals located within the merging hospitals' service area (this area satisfies the "little out from inside" test); finally, determine the area containing those hospitals that supply 90% of all the business that comes from patients residing in the collective service area (this area satisfies the "little in from outside" test). *Id.*

The standard articulated by the District Court in this case parallels the standard from *Rockford Memorial*, which the *Rockford Memorial* court acknowledged was based on

Elzinga-Hogarty. And the District Court's analysis here proceeded in accordance with the way it articulated the standard. Consistent with this "few patients leave … and few patients enter" test, the District Court relied primarily on the fact that 43.5% of Hershey's patients travel from outside of the Harrisburg area (the Government's proposed geographic market) in order to receive GAC services. This number is a measure of patient inflows—one of the two primary measurements relevant to the Elzinga-Hogarty analysis.

As the *amici curiae* Economics Professors[3] have persuasively demonstrated, patient flow data—such as the 43.5% number emphasized by the District Court—is particularly unhelpful in hospital merger cases because of two problems: the "silent majority fallacy" and the "payor problem." *See* Br. of *Amici Curiae* the District Court did not consider that Hershey is a leading academic medical center that provides highly complex medical services. We are skeptical that patients who travel to Hershey for these complex services would turn to other hospitals in the area.

Although the District Court did not employ strict cutoffs to determine whether too many patients enter or leave the proposed market, the silent majority fallacy renders the test employed by the District Court unreliable even in the

healthcare market is represented by a two-stage model of competition. *See St. Alphonsus,* 778 F.3d at 784 n.10 (calling the two-stage model the "accepted model"). In the first stage, hospitals compete to be included in an insurance plan's hospital network. In the second stage, hospitals compete to attract individual members of an insurer's plan. Gregory Vistnes, *Hospitals, Mergers, and Two-Stage Competition*, 67 Antitrust L.J. 671, 672 (2000). Patients are largely insensitive to healthcare prices because they utilize insurance, which covers the majority of their healthcare costs. Because of this, our analysis must focus, at least in part, on the payors who will feel the impact of any price increase. *Id.* at 682, 692.

The Hospitals argue that there is no fundamental difference between analyzing the likely response of consumers through the patient or the payor perspective. We disagree. Patients are relevant to the analysis, especially to the extent that their behavior affects the relative bargaining positions of insurers and hospitals as they negotiate rates. But patients, in large part, do not feel the impact of price increases.[6] Insurers do. And they are the ones who negotiate

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[6] The Hospitals put forth evidence that patients are becomingly increasingly sensitive to prices. Hosps. Br. 29. We do not disagree. But despite the increasing sensitivity of patients to pricing—e.g., through high-deductible plans, coinsurance, and tiered networks—the majority of patients do not feel the impact of the price of a specific procedure or at a specific hospital. The Hospitals' own study showed that only 2% of respondents considered out-of-pocket costs in choosing a hospital. Corrected Reply Br. 24. Moreover, the Hospitals have not drawn our attention to any specific evidence about the use of health plans that would result in price sensitivity to patients.

directly with the hospitals to determine both reimbursement rates and the hospitals that will be included in their networks.

Imagine that a hospital raised the cost of a procedure from $1,000 to $2,000. The patient who utilizes health insurance will still have the same out-of-pocket costs before and after the price increase. It is the insurer who will bear the immediate impact of that price increase. Not until the insurer passes that cost on to the patient in the form of higher premiums will the patient feel the impact of that price increase. And even then, the cost will be spread among many insured patients; it will not be felt solely by the patient who receives the higher-priced procedure. This is the commercial

We do not mean to suggest that, in the healthcare context, considering the effect of a price increase on patients constitutes error standing alone. Patients, of course, are relevant. For instance, an antitrust defendant may be able to demonstrate that enough patients would buy a health plan marketed to them with no in-network hospital in the proposed geographic market. It would necessarily follow that those patients who purchased the health plan would have to turn to hospitals outside the relevant market (lest they pay significant out-of-pocket costs for an out-of-network hospital). In this scenario, patient response is clearly important, but it is not important with respect to patients' response to the price increase demanded by the post-merger Hospitals. The District Court here did not address this correlated behavior. And although it is possible that this scenario could play out in some healthcare market, to assume that it would in Harrisburg defies the payors' testimony. The payors repeatedly said that they could not successfully market a plan

App. 14. It declined to make such a prediction "[i]n the rapidly-changing arena of healthcare and health insurance." *Id.*

This reasoning is flawed. We have previously cautioned that, in determining the relevant product market, private contracts are not to be considered. *See Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 438-39 (3d Cir. 1997). This same reasoning applies to the relevant geographic market. In determining the relevant market, we "look[] not to the contractual restraints assumed by a particular plaintiff," *id.*, but instead, we answer whether a *hypothetical* monopolist could profitably impose a SSNIP.

For this reason, private contracts between merging parties and their customers have no place in the relevant geographic market analysis. The hypothetical monopolist test is exactly what its name suggests: hypothetical. This is for good reason. If we considered the agreements, then our inquiry would be simple: the Hospitals would not be able to profitably impose a SSNIP because the agreements forbid them from doing so. Determination of the relevant geographic market is a task for the courts, not for the merging entities. Although the District Court declined to predict what might happen to negotiating position and rates, making predictions about parties' and consumers' behavior is exactly what we are asked to do. *See United States v. Phila. Nat'l Bank*, 374 U.S. 321, 362 (1963) (noting that the question "whether the effect of the merger 'may be substantially to lessen competition' in the relevant market" requires a "prediction of [the merger's] impact upon competitive conditions in the future").

Moreover, if we allowed such private contracts to impact our analysis, any merging entity could enter into similar agreements—that may or may not be enforceable—to

We emphasize, however, that our holding is narrow. We are not suggesting that the hypothetical monopolist test is the only test that the district courts may use in determining whether the Government has met its burden to properly define the relevant geographic market. In our case, the District Court, the Hospitals, and the Government all agreed that the hypothetical monopolist test was the proper standard to apply. The District Court identified the standard and purported to apply it. But in doing so, it incorrectly defined and misapplied that standard. This was error.

iv. The Government Has Properly Defined the Relevant Geographic Market

Our conclusion that the District Court incorrectly formulated and misapplied the proper standard does not end the inquiry. We must still determine whether the Government has met its burden to properly define the relevant geographic market. We conclude that it has.

membership in Dauphin County if they tried to market a plan that excluded Pinnacle and Hershey. Gov't Br. 13-14; Corrected Reply Br. 14 n.9.

He further testified that the insurer previously used the possibility of creating a network that included only Holy Spirit and Hershey in the Harrisburg market in order to get Pinnacle to accept lower prices. Corrected Reply Br. 13. According to him, insurers used the separate existence of Pinnacle and Hershey at the bargaining table: in order to resist a large price increase from Pinnacle, Payor A threatened to form a network with Holy Spirit and Hershey, excluding Pinnacle. After making this threat, Payor A and Pinnacle were able to come to an agreement that included only modest rate increases. The representative conceded that, without the ability to create a network with Hershey, this threat would not have been credible—Payor A could not have threatened to form a network with only Holy Spirit. Gov't Br. 15. This is strong evidence that the separate existence of Pinnacle and Hershey constrains prices.

A representative from a second large insurer, Payor B, August 2014, Pinnacle terminated its agreement with Payor E. After losing Pinnacle from its network, Payor E negotiated substantial discounts with Holy Spirit and large hospitals in York and Lancaster counties and was able to offer plans at a substantial discount. Despite being priced much lower than its competitors, Payor E lost half its members, who switched to other health plans. Gov’t Br. 13-14. Brokers informed the Payor E representative that it no longer had a viable network without Pinnacle, and even in the face of substantial discounts for Payor E’s health plan, patients were willing to pay more to other insurers for health plans that included Hershey or Pinnacle. Corrected Reply Br. 16.

Finally, payors testified that they von ide 8the

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leverage as a result of the merger will allow the post-merger combined Hershey/Pinnacle to profitably impose a SSNIP on payors.

All of the aforementioned evidence answered an even narrower question than the one presented: the Government was not required to show that payors would accept a price increase rather than excluding the merged Hershey/Pinnacle entity from their networks; it was required to show only that payors would accept a price increase rather than excluding *all* of the hospitals in the Harrisburg area. That is the inquiry under the hypothetical monopolist test. Considering the evidence put forth by the Government, we conclude that the Government has met its burden to properly define the relevant geographic market. It is the four-county Harrisburg area.

2. Prima Facie Case

“Once the relevant geographic market is determined, a prima facie case is established if the plaintiff proves that the merger will probably lead to anticompetitive effects in that market.” *St. Alphonsus*, 778 F.3d at 785. Market concentration is a useful indicator of the likely competitive, or anticompetitive, effects of a merger. *Merger Guidelines*, § 5.3, at 18; *see also H.J. Heinz*, 246 F.3d at 715-16 (“Increases in concentration above certain levels are thought to raise a likelihood of interdependent anticompetitive conduct.” (4ɿ m φ D ŋ p ʊ M othtion

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with a HHI above 2,500 is classified as "highly concentrated," and a merger that increases the HHI by more than 200 points is "presumed to be likely to enhance market power." *Id.* § 5.3, at 19. The Government can establish a prima facie case simply by showing a high market concentration based on HHI numbers. *See St. Alphonsus*, 778 F.3d at 788 ("The extremely high HHI on its own establishes the prima facie case."); *H.J. Heinz*, 246 F.3d at 716 ("Sufficiently large HHI figures establish the FTC's prima facie case that a merger is anti-competitive.").

The Government put forth undisputed evidence that the post-

> or economic debits and credits, it may be deemed beneficial. … Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.

374 U.S. at 371. Finally, in *FTC v. Procter & Gamble Co.*, 386 U.S. 568 (1967), the Supreme Court cautioned that

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concurring)). Finally, the efficiencies must not arise from anticompetitive reductions in output or service. *Merger Guidelines*, § 10, at 30.

Remaining cognizant that the "language of the Clayton Act must be the linchpin of any efficiencies defense," and that the Clayton Act speaks in terms of "competition," we must emphasize that "a successful efficiencies defense requires proof that a merger is not, despite the existence of a prima facie case, anticompetitive." *St. Alphonsus*, 778 F.3d at 790. The presumption of illegality may be overcome only where the defendants "demonstrate that the intended acquisition would result in significant economies and that these economies ultimately would benefit competition and, hence, merger specific, verifiable, and must not arise from any anticompetitive reduction in output or service.

capacity constraints because, upon consummating the merger, Hershey will immediately be able to transfer patients to Pinnacle. The District Court also credited the testimony of Hershey CEO Craig Hillemeier that, because Hershey will transfer patients to Pinnacle, it can avoid constructing a new planned bed tower aimed at providing additional beds at Hershey, resulting in capital savings of nearly $277 million.

The parties dispute whether capital savings can constitute efficiencies. *Compare FTC v. Butterworth Health Corp.*, 946 F. Supp. 1285, 1300-01 (W.D. Mich. 1996) (capital savings are cognizable efficiencies), *with FTC v. ProMedica Health Sys., Inc.*, No. 3:11-cv-47, 2011 WL 1219281, at *36-37 (N.D. Ohio Mar. 29, 2011) (capital savings are not cognizable efficiencies). We turn to the *Merger Guidelines* in answering this question. As the *Merger Guidelines* explain, competition is what "usually spurs firms to ac

enhance their efforts to engage in risk-based contracting. Riskengage in risk-based contracting, the Hospitals must demonstrate that such a benefit would ultimately be passed on to consumers. It is not clear from the record how this would be so beyond the mere assertion that it would save the Hospitals money and such savings would be passed on to consumers. We cannot credit the District Court's observation likelihood, and sufficiency." *Id.* The District Court noted that "the market that Hershey and Pinnacle exist within has already been subject to extensive repositioning." App. 23. It specifically noted that Geisinger Health System recently acquired Holy Spirit Hospital near Harrisburg; WellSpan Health acquired Good Samaritan Hospital in Lebanon County; the University of Pennsylvania acquired Lancaster

injunction and the FTC were to subsequently determine the merger is lawful. Although the Hospitals have indicated in their briefs to this Court that they "'would have to abandon the combination rather than continu[e] to expend substantial resources litigating' if an injunction is issued," Hosps. Br. 49 (quoting Hosps. Pre-Hrg. Br. 2), they offer no support beyond mere recitation that they would do so. Even more, the District Court made the exact opposite finding below. *See* App. 27 ("[W]e note that the parties have not emphasized, and we do not credit, any argument that an injunction would kill this merger … ." (internal quotation marks omitted)).

Nevertheless, even accepting the Hospitals' assertion that they would abandon the merger following issuance of the injunction, the result—that the public would be denied the procompetitive advantages of the merger—would be the Hospitals' doing. We see no reason why, if the merger makes economic sense now, it would not be equally sensible to consummate the merger following a FTC adjudication on the merits that finds the merger lawful.

On balance, the equities favor granting the injunction. None of the private equities, or those equities that may have public benefit, on the Hospitals' side of the ledger are sufficient to overcome the public's strong interest in effective enforcement of the antitrust laws. We recognize that certain extrinsic factors have made these types of mergers beneficial—perhaps even necessary—to the continued success of some hospital systems. Yet, in this case, we are tasked with deciding only whether preliminary injunctive relief would be in the public interest. Opining on the soundness of any legislative policy that may have compelled the Hospitals to undertake this merger is not within our purview.

V. Conclusion

We therefore conclude that, after determining the Government's likelihood of success and weighing the equities, a preliminary injunction would be in the public interest. Accordingly, we will reverse the District Court's denial of the Government's motion for a preliminary injunction. We will also remand the case and direct the District Court to preliminarily enjoin the proposed merger between Hershey and Pinnacle pending the outcome of the FTC's administrative adjudication.