The Antitrust Review of the Americas 2018

Published by Global Competition Review in association with

Analysis Group
Axinn, Veltrop & Harkrider LLP
Baker & Hostetler LLP
Baker & McKenzie LLP
Bennett Jones LLP
Borden Ladner Gervais LLP
Cooley LLP
Coronel & Pérez
Freshfields Bruckhaus Deringer US LLP
Goodwin Procter LLP
King & Spalding LLP
Machado Meyer
Norton Rose Fulbright
Orrick, Herrington & Sutcliffe LLP
Shearman & Sterling LLP
Thompson Hine LLP
Vinson & Elkins LLP
Von Wobeser y Sierra, SC
Weil, Gotshal & Manges LLP
White & Case LLP
Wilson Sonsini Goodrich & Rosati
Zürcher, Odio & Raven

www.globalcompetitionreview.com

GCR
GLOBAL COMPETITION REVIEW

United States: Economics

Dov Rothman and Samuel Weglein
Analysis Group

A merger may generate efficiencies that enhance the merged firm's ability to compete, potentially resulting in lower prices, improved quality, enhanced service, or new products. Under the US Department of Justice's (DOJ's) and Federal Trade Commission's (FTC's) Horizontal Merger Guidelines (HMG), efficiencies are cognisable – that is, credited when a merger is being reviewed – only if they are:

- likely to be accomplished by the proposed merger (verifiable);
- unlikely to be accomplished in the absence of the proposed merger or other means having comparable anticompetitive effects (merger-specific); and
- do not arise from anticompetitive reductions in output or service.[1]

Furthermore, for cognisable efficiencies to offset the anticompetitive effects of a merger, they must be of sufficient magnitude and be passed through to customers.

Claimed efficiencies were an important part of two contested healthcare industry mergers in 2016: *Anthem/Cigna*, and *Penn State Hershey Medical Center/PinnacleHealth System*. In both proposed mergers, the merging parties argued efficiencies would offset the harm to competition otherwise caused by the elimination of head-to-head competition; the relevant agency, on the other hand, argued that the claimed efficiencies were not cognisable or would not be passed through to consumers.[2] In both cases, the relevant court sided with the government, concluding that claimed efficiencies were not enough to offset the harm to competition.

In this article, we summarise the efficiency arguments offered by the merging parties in *Anthem/Cigna* and *Hershey/Pinnacle*, the government's responses to those arguments, and the court's decision.

Anthem/Cigna

Overview

Anthem and Cigna are the second and fourth-largest commercial health insurance carriers in the United States by enrolment.[3,4] In 2015, Anthem had 38.6 million members.[5] The firm is based in Indianapolis, Indiana, and holds exclusive licence to use the Blue Cross and/or Blue Shield brands in 14 states.[6] In 2015, Cigna had approximately 15 million members. The firm is based in Bloomfield, Connecticut, and operates in all 50 US states and the District of Columbia. Outside the United States, Cigna operates in more than 30 countries.

On 23 July 2015, Anthem and Cigna entered into an agreement and plan of merger valued at approximately US$54.2 billion. The merging parties agreed that Anthem would own 67 per cent of the joint equity, while Cigna would own 33 per cent. On 3 December 2015, the shareholders of both firms approved the transaction.

Integration efforts between the two firms began in December 2015; over time, discussions between the two firms became more contentious. Cigna was concerned with Anthem's approach to medical providers and its plan to move members from the Cigna brand to the Anthem brand. For its part, Anthem expressed concern about the pace and quality of the integration efforts and the amount of data and information being shared. By April 2016, Cigna had slowed its participation in integration efforts; with the filing of the lawsuit to enjoin the merger, Cigna completely stopped all its efforts.

On 21 July 2016, the US Department of Justice, 11 US states,[7] and the District of Columbia filed a joint lawsuit to enjoin the merger on the grounds that it would violate section 7 of the Clayton Act. Specifically, the plaintiffs alleged the proposed transaction would harm competition in multiple relevant antitrust markets, including:

- the sale of commercial health insurance services to national account customers in Anthem's 14 territories and the United States;
- the sale of commercial health insurance services to large groups in 35 local markets within the 14 Anthem territories; and
- the purchase of commercial health services in those same 35 local markets.

The plaintiffs also alleged the transaction would result in a loss of innovation.

A prominent feature of Anthem's case was its contention that self-insured employers would benefit from a transaction that increased Anthem/Cigna's buy-side and sell-side market power. Anthem argued the transaction would enable Cigna to reduce payments to providers, and that the benefits of these payment reductions would flow to employers. The cost savings on medical care would – according to Anthem – swamp any harm (eg, higher administrative fees) caused by losing head-to-head competition between Anthem and Cigna. The DOJ argued that this form of rent transfer is not an efficiency, and that it was neither merger-specific nor verifiable, and therefore not cognisable.

On 8 February 2017, following a six-week bench trial, Judge Amy Berman Jackson of the US District Court for the District of Columbia granted a permanent injunction to enjoin the merger. Judge Jackson ruled that the defendants had provided insufficient evidence of efficiencies to counter the anticompetitive effects of the merger. The district court's decision also stated that the potential medical network savings related to the merger were not merger-specific or verifiable, and should not be considered efficiencies at all. Anthem appealed the district court's decision, arguing that the district court improperly declined to consider the claimed billions of dollars in medical savings.

On 28 April 2017, the US Court of Appeals for the District of Columbia affirmed Judge Jackson's ruling. The appeals court addressed Anthem's efficiency defence, agreeing that Judge Jackson had reasonably concluded that Anthem had failed to demonstrate merger-specific efficiencies that could offset likely price increases and that could mitigate the loss of innovation.

Anthem's efficiency defence

While Anthem challenged the DOJ's competitive effects analysis, claimed efficiencies also were a key feature of Anthem's defence. Anthem maintained that historically it has been able to negotiate

lower rates with medical care providers than has Cigna, due to Anthem's large number of subscribers. Anthem also argued that its lower rates would be enjoyed by Cigna's customers post-merger; it estimated that the newly merged company would be able to realise US$2.4 billion in medical cost savings, and that nearly all of those savings would be passed through to consumers, because the majority of national accounts are self-insured.[8]

Anthem pointed to three mechanisms that would enable it to achieve these cost savings. First, in many of its contracts with providers, it had an 'affiliate clause' that would enable it to apply the negotiated rate to any of its affiliates; post-merger, that clause could be exercised with respect to the Cigna customers who received care from those same providers. Second, it argued that by virtue of its even greater scale, it could re-negotiate its rates with providers and achieve rates at least as good as the rates it had negotiated pre-merger (which would apply to all customers, including those that had been Cigna customers previously). Third, it argued it would engage in serious 're-branding' efforts to induce Cigna customers to migrate to Anthem products – thus, even if the first two mechanisms were not available, the migration to Anthem products would bring with it cost savings, owing to the lower provider rates.

Ultimately, Anthem argued its customers would enjoy the best of both worlds as a result of the merger – that is, customers would get all of the benefits of Cigna's innovative products, but would pay a lower Anthem rate for that higher-quality product. It argued further that the benefit from the reduced medical costs for Cigna's customers accessing Anthem's lower prices (along with the ability of the merged firm to negotiate lower rates) would more than offset the potential anticompetitive harm resulting from the merger.

The government's response

The DOJ countered Anthem's efficiency claims, arguing that: (i) the cost savings were not merger-specific; (ii) the magnitude of the cost savings was speculative and unverifiable; and (iii) the cost savings – which reflected transfers from providers to the merged entity – could not be credited as efficiencies in any case.

To fully appreciate the DOJ's first argument – lack of merger specificity – it is important to consider constraints that Anthem faced as a member of the Blue Cross Blue Shield Association. Of particular relevance are a set of rules known as 'Best Efforts' rules, which, among other things, require each licensee in the Association to earn at least 80 per cent of its in-territory revenue (and 66 per cent nationally) from Blue-branded products. By virtue of Cigna's size relative to Anthem, the new entity would be out of compliance with the Best Efforts rules immediately and would be required to come into compliance. Particularly in the 14 Anthem states, Anthem would have an incentive (and indeed planned) to move as many Cigna customers to Anthem products as possible, to come into compliance with the Best Efforts rules.

Consequently, while Anthem claimed that it would ultimately be able to develop a Blue-branded product that had all of the best features of Cigna's innovative products and Anthem's low-cost products, the DOJ argued that there was no concrete plan for doing so in the near term. Furthermore, there was reason to expect that doing so would be difficult, because providers who had developed innovative offerings with Cigna would balk at the notion of continuing to do so in the face of lower payments.

At least in the short run, the DOJ argued, Anthem would simply attempt to induce Cigna customers to switch from their existing Cigna plan to an existing Anthem plan (through lower pricing, increased and targeted marketing, etc). While doing so would generally give the employer access to lower provider rates, the DOJ argued this was not merger-specific; even absent a merger, Anthem could target Cigna customers and induce them to switch to Anthem, and if the customer chose to do so, it would enjoy the same cost savings that Anthem claimed as merger efficiencies. Furthermore, even if one accepted the premise that Anthem's low rates could coexist with innovative products like those sold by Cigna, the DOJ argued that Anthem did not need to merge with Cigna to achieve that – it already had the resources to develop similar products.

The DOJ also argued that the cost savings put forward by Anthem were speculative and unverifiable. The DOJ questioned Anthem's calculations and argued that alternative analyses put forward by Anthem implied considerably lower cost savings. In addition, the DOJ argued that because of the discord between Anthem and Cigna, there was no clear plan for the integration of the two firms, which would be a necessary predicate for the creation of the sort of 'best of both worlds' product that Anthem envisioned. Indeed, as discussed above, the DOJ expressed scepticism that providers would continue to collaborate with the post-merger firm – as they had been doing with Cigna – if forced to accept lower rates.

The DOJ also pointed out that, while Anthem may have had affiliate clauses in its contracts with certain providers, exercising them post-merger would have been counterproductive because Cigna customers would face no incentive to migrate to a Blue-branded product. Thus, in order to regain compliance with the Best Efforts rules, the post-merger company likely would be hesitant to exercise the affiliate clause.

The DOJ also questioned whether these claimed medical cost savings are even efficiencies. The DOJ maintained that none of the claimed medical cost savings arose from more efficient delivery of care or creation of new demand – they merely reflected a transfer from providers to the merged firm, and to the extent that there would be pass-through, to the firm's customers. This does not constitute an efficiency in its true sense, the DOJ argued. The DOJ also pointed out that under the most realistic scenario (ie, rebranding), while migration from Cigna to Anthem gives an employer lower provider prices in general, the employer is also getting a lower-quality product. This, the DOJ argued, should not be considered an efficiency.

The court's ruling

Judge Jackson, in rejecting Anthem's efficiencies argument, generally echoed the DOJ's arguments – while she agreed with Anthem that an efficiencies defence is available, she found that the claimed efficiencies here were not cognisable. First, she found that the claimed efficiencies were not merger-specific ('Not one penny of these savings derives from anything new, improved, or different that the combined company would bring to the marketplace that neither company can achieve alone'). In doing so, she rejected Anthem's claim that the medical cost savings were a form of a bulk discount. She also pointed out that none of the popular specialty services currently offered by Cigna were proprietary, so that Anthem could have duplicated them on its own.

Judge Jackson also questioned the verifiability of the magnitude of the cost savings and the time frame in which they would be realised, pointing, for example, to testimony from Anthem CEO Joe Swedish that even if Anthem had the ability to 'drop the hammer' on the providers, it would resist doing so. She also questioned the calculation itself, crediting testimony from Cigna CEO David Cordani, who noted the model's focus on differences between the

negotiated Anthem and Cigna provider prices, without taking into account differences in utilisation that would affect the overall cost of care.

Judge Jackson also grappled with the question of what constitutes a cognisable efficiency. First, she accepted the DOJ's argument that the claimed medical cost savings do not reflect true economic efficiencies: 'the promised reduction in customers' total medical costs does not result from either company doing anything better, or from the elimination of duplication or the creation of new demand. It does not result from the carriers' or the providers' operating more efficiently, and there has been no showing that the merger will result in increased output or enhanced quality at the same cost.'

Hershey/Pinnacle

Overview

Penn State Hershey Medical Center (Hershey) is located in Hershey, Pennsylvania. It has over 550 beds, employs over 800 physicians, and provides all levels of care, including complex, specialised services that are unavailable at other hospitals in the area. PinnacleHealth System (Pinnacle) operates three hospital campuses – West Shore Hospital, Harrisburg Hospital, and Community General Osteopathic Hospital. It has over 600 beds, employs several hundred physicians, and focuses on primary and secondary services, while offering a limited range of more complex services.

Hershey and Pinnacle (hereafter, 'the Hospitals') signed a letter of intent to merge in June 2014. Their respective boards approved the merger in March 2015, and they notified the FTC in May 2015. In December 2015, the FTC filed an administrative complaint seeking a preliminary injunction, alleging that a merger would violate section 7 of the Clayton Act. The FTC then filed suit in the Middle District of Pennsylvania.

The government alleged the merger would substantially lessen competition in the market for general acute care services sold to commercial insurers in the Harrisburg, Pennsylvania market. The Hospitals countered that the relevant geographic market was much broader than the Harrisburg area, and that efficiencies would more than offset any loss of competition caused by the transaction. The district court held five days of evidentiary hearings, and subsequently denied the government's request for a preliminary injunction on the basis that the government had not properly defined the relevant geographic market. The government appealed the district court's ruling. The appeals court heard the appeal and subsequently reversed the district court's ruling that the government had not properly defined the relevant geographic market. The appeals court in its ruling also addressed the Hospitals' efficiency defence.

Hershey/Pinnacle's efficiency defence

The Hospitals offered two broad efficiency arguments. First, the Hospitals argued the merger would relieve Hershey's capacity constraints by enabling patients to be transferred to Pinnacle, which, in turn, would enable Hershey to avoid construction of a 100-bed tower. Hershey estimated that not constructing the planned bed tower would result in nearly US$277 million in avoided capital expenditures, and argued that these avoided capital expenditures would be passed through to payers and patients in the form of lower prices. Second, the Hospitals argued that the larger merged entity would be better able to engage in risk-based contracting, which is an alternative payment model to traditional fee-for-service in which healthcare providers assume some of the financial risk and upside in the cost of treatment.

The government's response

The government challenged the Hospitals' efficiency claims. With regard to the avoided capital expenditure claim, the government argued that (i) not building the planned bed tower was a reduction in output, and so the avoided capital expenditures were not cognisable because they arose from an anticompetitive reduction of output, and (ii) the avoided capital expenditures would not enhance competition because they likely would not be passed through to payers. Capital expenditures are fixed costs, and microeconomic principles suggest that fixed costs are generally not passed through to consumers. With regard to the risk-based contracting claim, the government argued the merger was not necessary to achieve any such benefits because Hershey and Pinnacle were already large enough to enter into and pursue such arrangements with payers.

The district court's ruling

The district court ruled that the government had not set forth a relevant geographic market and denied the government's request for injunctive relief on the grounds that the government had not demonstrated a likelihood of ultimate success on the merits. The district court also ruled that the Hospitals had presented a compelling efficiencies argument that the merger would alleviate some of Hershey's capacity constraints, and that the merger would facilitate adaptation to risk-based contracting, while noting that Hershey and Pinnacle were each independently capable of continuing to operate under the risk-based model.

The appeals court ruling

The appeals court reversed the district court's ruling that the government did not define a relevant geographic market, and it also weighed in on the Hospital's efficiency claims. With regard to the avoided capital expenditure claim, the appeals court first recognised that avoided capital expenditures could be relevant to an efficiencies analysis, but to be cognisable would need to be verifiable and not a result of anticompetitive reductions in output. Turning to the *Hershey/Pinnacle* transaction specifically, the appeals court questioned whether Hershey really needed to construct a 100-bed tower to alleviate capacity constraints. It pointed to evidence that the hospitals only needed to add 13 beds to operate at optimal capacity, while also ruling that even if Hershey did add the bed tower, the avoided capital expenditures associated with not building the planned bed tower were not cognisable because failing to build the bed tower was an anticompetitive reduction in output, as the government had argued. With regard to the Hospitals' risk-based contracting claim, the appeals court questioned whether the benefits of risk-based contracting would be passed through to payers and patients and whether any benefits of risk-based contracting were merger-specific, considering that Hershey and Pinnacle were both already engaged in risk-based contracting.

Conclusion

Courts tend to cast a sceptical eye toward efficiency defences, particularly when the efficiencies extend beyond the typical and generally defensible (in concept, if not in magnitude) arguments about reductions in selling, general, and administrative expenses (SG&A), and these two cases proved no different. Anthem argued that the transaction would enable Cigna to reduce payments to providers, and that the benefits of these payment reductions would flow to consumers. Hershey argued that the transaction would enable it to avoid making a large capital expenditure, and that the benefits of the avoided capital expenditure would flow to payers and consumers.

But, while the efficiency defences themselves were somewhat unique, the criteria used by the courts were not. In both cases, the courts asked whether the claimed efficiencies were merger-specific and verifiable; in both cases, the courts concluded that they were not.

Notes

1 Horizontal Merger Guidelines (2010) (HMG), at § 10.

2 The DOJ reviewed and challenged the *Anthem/Cigna* transaction. The FTC reviewed and challenged the *Hershey/Pinnacle* transaction.

3 Frank G Morgan, Anton Hie, and Ben Hendrix, 'The Managed Care Industry: A Primer with Perspective as Consolidation Begins,' RBC Capital Markets, 23 June 2015, p. 25.

4 Morgan, Hie, and Hendrix, 'The Managed Care Industry,' p. 4.

5 Anthem 2015 10-K, p. 3.

6 California (Blue Cross licence only), Colorado, Connecticut, Georgia, Indiana, Kentucky, Maine, Missouri (excluding 30 counties in western Missouri), Nevada, New Hampshire, New York (excluding certain areas), Ohio, Virginia (excluding certain counties near Washington, DC), and Wisconsin.

7 The states were California, Colorado, Connecticut, Georgia, Iowa, Maine, Maryland, New Hampshire, New York, Tennessee, and Virginia.

8 Anthem enjoyed a rate advantage over Cigna with most providers. In some instances, Cigna's rate was lower than Anthem's rate. A non-trivial portion of the US$2.4 billion reflects claimed savings to Anthem's customers for those providers where Cigna enjoyed a rate advantage.

Dov Rothman
Analysis Group

Dr Rothman is an economist with significant experience in merger analysis. He recently provided support to the DOJ's testifying economist in its challenge of the *Anthem/Cigna* merger, the FTC's testifying economist in its challenge of the *Penn State Hershey Medical Center/PinnacleHealth* merger, and the DOJ's consulting economist in its review of the *Alaska Airlines/Virgin America* merger. He also recently led a team of consultants working on behalf of the FTC in its review of the *Reynolds/Lorillard* merger.

Dr Rothman has testified as an expert on antitrust issues and has published research in outlets, including the *Journal of Health Economics*, *Journal of Competition Law & Economics*, *Concurrences: Competition Law Journal* and the ABA Antitrust Section's *Econometrics: Legal, Practical and Technical Issues*. Dr Rothman teaches a course on the economics of merger analysis in the economics department at Harvard University and is an associate editor of the *Antitrust Law Journal*. Prior to joining Analysis Group, Dr Rothman was an assistant professor at Columbia University.

Samuel Weglein
Analysis Group

Dr Weglein consults on cases requiring economic analyses and damages estimates in antitrust, finance and securities, intellectual property, and general business litigation. He has worked on mergers in the insurance industry and has provided expert support in antitrust litigation in the health insurance market, including the *Anthem/Cigna* merger trial.

In several large antitrust litigations involving alleged anticompetitive conduct by Microsoft, Dr Weglein analysed the economics of prepackaged software and managed projects to assess potential damages; he also worked on behalf of Intel in antitrust litigation brought by AMD and by the State of New York. Dr Weglein has also worked on antitrust litigation in a number of financial markets, including financial pricing benchmarks, private equity and credit default swaps. His experience spans numerous industries, including investment and commercial banking, securities brokerage and clearing, asset management, semiconductors, computer hardware and software, oil and gas, automotives, steel, real estate, medical devices, agribusiness, and biotechnology. Dr Weglein is also the co-author of two white papers addressing competition issues in the automotive industry.

ANALYSIS GROUP
ECONOMIC, FINANCIAL and STRATEGY CONSULTANTS

111 Huntington Avenue, 14th Floor
Boston, MA 02199
United States
Tel: +1 617 425 8000
Fax: +1 617 425 8001

Dov Rothman
dov.rothman@analysisgroup.com

Samuel Weglein
samuel.weglein@analysisgroup.com

www.analysisgroup.com

Analysis Group is one of the largest private economics consulting firms, with approximately 750 professionals across 13 offices in North America, Europe, and Asia. Since 1981, we have provided expertise in economics, finance, healthcare analytics, and strategy to top law firms, Fortune Global 500 companies, and government agencies worldwide. Our internal experts, together with our network of affiliated experts from academia, industry, and government, offer our clients exceptional breadth and depth of expertise.

Competition has been a core focus of our work since our inception. We integrate industrial organisation theory, industry-specific expertise, and the latest quantitative analytical methods to understand the conduct and market dynamics at issue in antitrust litigation and merger investigations. We have demonstrated our expertise in complex assignments related to class certification, liability, damages, and the competitive effects of proposed mergers and acquisitions. Our competition work covers a range of industries and markets, including high tech, financial products, manufacturing products, insurance, health care and pharmaceuticals, agriculture, and many others. Over the last decade, we have provided support to internal and external experts in some of the most significant mergers and government competition investigations. We have also been involved in numerous high-profile monopolization cases involving such companies as Microsoft and Intel, as well as some of the largest cartel cases in industries including credit cards, vitamins, TFT-LCD panels, cathode ray tubes, and auto parts. We have also been involved in a number of recent high-profile reverse-payment, product-hopping, and delayed generic entry matters in the pharmaceutical industry.

ABA Section of International Law
Your Gateway to International Practice

Strategic Research Sponsor of the
ABA Section of International Law

Law
Business
Research

THE QUEEN'S AWARDS
FOR ENTERPRISE:
2012

THE ANTITRUST REVIEW OF THE AMERICAS 2018 ISSN 1468-7054