Best Practices For Health Care Mergers In The COVID-19 Era

By **Steve Vieux, Peter O'Neill and Bria Davis** (September 16, 2020)

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Providers of health care services continue to suffer significant financial hardship caused by the COVID-19 pandemic. Recent figures from the American Hospital Association estimate that hospitals and health systems will suffer losses of at least $323 billion by year's end.[1]

Unsurprisingly, independent physicians have fared no better. One recent study estimated that primary care practices nationwide can expect to lose a total of $15 billion by the end of 2020,[2] while another found that 75% of physicians believe their practices will not make a profit in 2020.[3]

These losses are primarily driven by the reduction in revenue-enhancing elective and outpatient procedures as well as office visits. Patient volumes at AHA-member hospitals have decreased by 19.5% for inpatient services and by 34.5% for outpatient services, with 67% of hospitals reporting they do not expect to reach baseline volumes by the end of the year.[4]

The rising costs associated with treating COVID-19 patients and complying with a rapidly changing regulatory landscape only add to this financial strain. Such costs include those associated with: (1) reserving intensive care unit beds for COVID-19 patients; (2) maintaining an adequate reserve of personal protective equipment; and (3) screening and testing patients, physicians and medical personnel.[5] Most agree that these costs will increase over the fall and winter as states continue to reopen their economies, infection rates rise and flu season approaches.

Faced with these pressures, many providers are considering consolidation with larger health systems to provide them with financial and operational security. Some providers are even looking to investors with health care experience, such as private equity groups, for needed infusions of cash.

Consolidation within the health care industry has been increasing over the last few decades.[6] Most industry experts expect to see these historical trends continue in the wake of the pandemic.[7] So far, the volume of hospital-related transactions has remained relatively steady compared to 2019 figures.[8]

On the physician side, a recent survey found that independent physicians are increasingly looking to align with another entity to avoid financial ruin. Specifically, 53% of independent physicians reported they were worried about their practices surviving the pandemic, and almost 50% claimed they had less than four weeks of cash on hand.[9]

A significant number of independent physicians said they were considering partnering with another entity or selling their practice, with 68% of those interested citing financial strain as the primary reason.[10]

Benefits and Concerns Associated With Consolidation

Proponents of consolidation typically highlight the operational and clinical efficiencies that can be achieved. Such efficiencies include the increased coordination and standardization of

patient care, the ability to implement centralized electronic health records and financial accounting systems, and the ability to take on risk-based contracting and joint purchasing agreements.[11]

Proponents also argue that the increased emphasis on the pay-for-value reimbursement model requires providers to scale their services to prevent high-cost patients from undermining a provider's financial stability.[12] Detractors of consolidation argue that it increases the cost of health care and may even negatively impact outcomes for patients. Some have pointed to studies claiming a connection between hospital consolidation and an increase in prices for hospital stays.[13]

Horizontal or Vertical Merger Consolidation

Antitrust enforcers, whether the U.S. Department of Justice, Federal Trade Commission or state attorneys general, have traditionally focused on horizontal consolidation, i.e., mergers and acquisitions between two providers competing at the same level of the health care delivery chain.

An example would be a merger between two acute care hospitals or two physician practice groups serving patients in the same geographic area(s). The potential threat to competition and resulting harm to consumers through increased prices or reduction in quality is more readily apparent through such transactions. As a result, enforcers are likely to continue their focus on horizontal consolidation.

Vertical consolidation, such as hospital systems acquiring physician practice groups, also raise competitive issues that have concerned enforcers. Such mergers raise concerns over the foreclosure of a significant portion of the market by a merged entity away from its competitors, or the entity's ability to raise their competitors' costs.

For example, a hospital system that acquires the leading primary care physician practice group in an area might try to refer the majority or most profitable patient volumes to its own hospitals to the detriment of competing hospital systems.

Despite this risk, enforcers generally recognize the potential cognizable efficiencies that benefit competition and consumers through vertical mergers.[14] Such efficiencies include the elimination of double marginalization and streamlining production costs as well as innovation and improvements in quality through the combination of research and development efforts. In the health care context, this can translate into the coordination of care through increased clinical integration of complementary providers along the delivery chain.

Antitrust Considerations and Potential Defenses

An antitrust analysis of all mergers will take into account potential efficiencies and improvements in health care quality. With the emphasis on coordinated care as a way to improve quality and blunt rising costs, enforcers are likely to consider such claimed efficiencies with a healthy dose of skepticism.

That is why it is important that the merging parties substantiate all claimed efficiencies, not just state them. Ideally, the parties took such efficiencies into account at the start of the merger planning process, with such efficiencies playing a significant role in driving the transaction. Such efficiencies include:

- Improving providers' capability to manage population health, which is especially relevant in the middle of a public health crisis;

- Coordinating the provision of care to improve outcomes and control utilization costs;

- Improving analytics by accessing more key health data;

- Bringing essential health care services to unserved or underserved geographic regions and demographics (i.e., rural populations).

The merging parties should also be able to articulate how the above-listed efficiencies, among others, cannot be realized as fully through arms-length, nonmerger affiliations. A vertical merger among complementary providers may be better positioned to show the above-listed efficiencies than a horizontal merger, especially as it relates to the coordination of care among complementary providers, from primary care providers to specialists to acute care services.

Another difficulty horizontal combinations face under antitrust scrutiny is the more readily apparent reduction in direct competitors in the market, and the resulting increase in the merged entity's bargaining leverage in health care contract negotiations due to its increased market share at one necessary level of the health care delivery chain.

With a vertical merger, such harm is less likely to occur. Although, the vertically merging parties should take into account instances in which they do compete directly, such as in a hospital-physician practice merger in which the hospital-owned physician practice competes with the soon to be acquired physician group.

For vertical mergers, the perceived anti-competitive threat is further reduced if reasonable alternatives exist at the relevant levels of the delivery chain, thereby reducing the risks of foreclosure.

Failing Firm Defense

In these times, merging parties may be tempted to justify the acquisition of an entity as preventing the exit of that entity from the market due to financial failure. Traditionally, the bar to establish this failing firm defense has been high, and enforcers have been skeptical of it.[15]

However, given the pandemic's drastic economic effects on health care entities, parties may be more likely to meet the hurdles needed to satisfy the defense, which requires a showing that the allegedly failing firm: (1) would be unable to meet its financial obligations in the near future; (2) would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than the proposed merger.

As with merger efficiencies, parties using this defense must strongly substantiate their claims. Poor, or even drastically poor, recent financial performance is not enough. The parties must be able to convince an enforcer that without the combination, one or both parties and their assets will leave the market. They must show that any potential anti-competitive risks posed by the acquisition will be outweighed by the anti-competitive certainty of a lost market participants.

Such items of proof for providers would include negative cash flow, limited days of cash on hand and other milestones of imminent failure, such as key physician members leaving the group, in the case of physician practices.

The failing firm must also show that they made a good-faith effort to elicit a bona fide offer from an alternative buyer that poses less risk to competition. A perfunctory search for an alternative buyer will not satisfy this element of the defense.

State Advance Notification Requirements

Even before the pandemic, state authorities expressed concerns about the impact of increasing consolidation in health care services. Out of that concern, lawmakers have considered the implementation of premerger notification requirements for transactions involving health care services, regardless of size.

Such regulations would allow state antitrust enforcers to prospectively prevent problematic combinations before the eggs are scrambled. Washington already has such a law on the books, effective as of Jan. 1.[16]

Washington's law requires advance notification of a transaction between two or more health care systems, facilities or provider organizations that creates a material change, such as a merger or acquisition, to be sent to the state attorney general at least 60 days before the effective date of the transaction.

The notice should include basic information identifying the parties to the transaction, their location(s), the services provided by each party, and the nature and purpose of the transaction.[17] After notice is give, the attorney general has 30 days to request further information.[18]

The California Senate recently passed a bill, S.B. 977, requiring advance notice of certain health care transactions.[19] It is currently awaiting approval from the state legislature's lower house. Unlike Washington's law, California's bill goes beyond transactions solely involving health care providers and includes transactions involving hedge funds and private equity groups.

S.B. 977 also looks to be much more detailed and complex. It requires a health care system, private equity group or hedge fund to file written advance notice with the California attorney general and obtain written consent before executing a transaction involving a change in control or acquisition of a health care facility or provider.

The notice should include enough information about the nature of the transaction that is sufficient to enable the attorney general's office to evaluate it and determine whether it will result in a substantial likelihood of clinical integration, increase the availability and access of health care services to an underserved population, or both.

The bill defines clinical integration as a reduction in costs to the benefit of consumer care and outcomes, or an increase in the quality of care. Within 60 days of receiving written notice, the attorney general must either notify the submitter that it has cleared the transaction, request additional information from the parties, or grant a waiver.

Conclusion

As health care providers adapt to the unique financial stresses imposed on them by COVID-19, they should consider trends in antitrust enforcement in their sector and seek out counsel with specific experience in health-care-related antitrust issues and claims. Any mergers or acquisitions should be driven by the cost- and quality-related efficiencies that can be substantiated.

Further, any potentially anti-competitive transaction precipitated by claims of financial distress should be substantiated with evidence of an imminent market exit and good faith efforts to seek a less anti-competitive solution. Providers should also be aware of current and pending legislative initiatives requiring advance notification of combinations in the state(s) in which they operate, as such initiatives are likely to increase in the future.

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[1] https://www.aha.org/issue-brief/2020-06-30-new-aha-report-finds-losses-deepen-hospitals-and-health-systems-due-covid-19.

[2] https://www.healthaffairs.org/doi/full/10.1377/hlthaff.2020.00794.

[3] https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/physician-employment-the-path-forward-in-the-covid-19-era#.

[4] https://www.aha.org/issue-brief/2020-06-30-new-aha-report-finds-losses-deepen-hospitals-and-health-systems-due-covid-19.

[5] https://www.aha.org/issue-brief/2020-06-30-new-aha-report-finds-losses-deepen-hospitals-and-health-systems-due-covid-19.

[6] https://www.kff.org/health-costs/issue-brief/what-we-know-about-provider-consolidation/; https://www.healthaffairs.org/do/10.1377/hblog20200413.223050/full/

[7] https://www.healthaffairs.org/do/10.1377/hblog20200728.592180/full/

[8] https://www.kaufmanhall.com/sites/default/files/documents/2020-04/ma_quarterly_activity_report_-_q1_2020_kaufmanhall.pdf; https://www.kaufmanhall.com/sites/default/files/documents/2020-07/Q2_2020_Mergers_Acquisitions_Report_KaufmanHall.pdf.

[9] https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/physician-employment-the-path-forward-in-the-covid-19-era#

[10] https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/physician-employment-the-path-forward-in-the-covid-19-era#

[11] https://www.aha.org/system/files/2018-04/Hospital-Merger-Full-Report-FINAL-1.pdf

[12] Id.

[13] https://www.kff.org/health-costs/issue-brief/what-we-know-about-provider-consolidation/

[14]See DOJ/FTC, Vertical Merger Guidelines, at 11 (June 30, 2020).

[15] "On 'Failing' Firms- And Miraculous Recoveries," Competition Matters Blog, https://www.ftc.gov/news-events/blogs/competition-matters/2020/05/failing-firms-miraculous-recoveries

[16] See Wash. Rev. Code §§ 19.390.010–19.390.90.

[17] Wash. Rev. Code § 13.390.040.

[18] Wash. Rev. Code § 13.390.050.

[19] SB-977 Health care system consolidation: Attorney General Approval and Enforcement (http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201920200SB977).