June 12, 2024

Hospitals Defeat FTC Merger Injunction Request With a Version of the "Failing Firm" Defense

- In a recent hospital merger challenge brought by the FTC, defendants successfully asserted a version of the "failing firm" defense to avoid a preliminary injunction.
- Even though the FTC lost, the court's evaluation of the defense was generally in line with the Merger Guidelines.
- However, the court's reasoning suggests that in some circumstances defendants may assert the failing firm defense successfully without having to adhere rigidly to each and every purported element stated in the guidelines.
- Here, the court appears to have allowed the defense where the "failing firm" is apparently undergoing an out-of-court reorganization involving the sale or shuttering of some facilities.

On June 5, 2024, Judge Kenneth D. Bell of the United States District Court for the Western District of North Carolina denied the request of the Federal Trade Commission (FTC) for a preliminary injunction preventing Novant Health, Inc. from acquiring the Lake Norman Regional Medical Center and Davis Regional Psychiatric Hospital from Community Health Systems, Inc. while a related FTC administrative proceeding is pending. Both of the facilities to be acquired are located within approximately 17 miles of each other in an area north of Charlotte, and the Lake Norman hospital is approximately 12 miles from a Novant hospital.

In reaching this decision, the court found that the FTC met its initial burden under the applicable standard of demonstrating a likelihood of success in proving a prima facie case that "the effect of the acquisition may be substantially to lessen competition, or to tend to create a monopoly" in violation of section 7 of the Clayton Act. But the court went on to find that the defendants met their burden of rebutting the prima facie case by demonstrating that there are "bona fide economic difficulties which are so existential as to establish that the entity being acquired will no longer be a viable competitor in the absence of the proposed transaction" and that the equities favored denial of the FTC's injunction request.

The FTC filed a notice of appeal. Judge Bell declined to issue an injunction pending appeal but extended an earlier temporary restraining order until June 21 to allow time for the FTC to move the Fourth Circuit for an injunction.

Standard for preliminary injunction in cases brought under section 13(b) of the FTC Act

In late January, FTC complaint counsel filed an administrative complaint challenging Novant's acquisition of the Lake Norman and Davis facilities. In order to prevent the parties from closing their transaction during the pendency of the administrative proceeding, complaint counsel also filed an action in federal district court for a preliminary injunction under section 13(b) of the FTC Act. Section 13(b) permits a court to issue a preliminary injunction "[u]pon a proper showing" by the FTC "that, weighing the equities and considering the Commission's likelihood of ultimate success" in proving in an administrative hearing that the

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acquisition violates section 7, the issuance of a preliminary injunction “would be in the public interest.” (This is different from the general preliminary injunction standard.)

Citing case law from several other circuits, the court wrote that for the FTC to demonstrate the requisite likelihood of success, it “must raise questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation, and determination by the FTC in the first instance and ultimately by [a] Court of Appeals” (which is where appeals from Commission decisions are taken). Notably, the court found that the FTC’s proposed standard of a “fair or tenable chance of success on the merits” and the defendants’ proposed standard of “a clear showing of likelihood of success” on the merits did not “comport with” the law and were “off the mark.”

Prima facie case: effects of the proposed acquisition on market concentration

The court applied a “burden-shifting analysis” to evaluate the likely effect of the acquisitions under the governing substantive law (section 7 of the Clayton Act) and determined that the FTC would likely meet its initial burden to show that the acquisitions would result in “a firm controlling an undue percentage share of the relevant market” and “a significant increase in the concentration of firms in that market.”

The court first determined that, in line with other hospital merger cases, the relevant market is “the cluster of inpatient general acute care services provided by both Novant and [the Lake Norman hospital] that are covered by commercial health plans” and that the defendants’ post-acquisition combined market share would be greater than 30% (a level of concern that the court noted was added to the 2023 Merger Guidelines).

The court also found that the market would be “highly concentrated” after the acquisition according to the Herfindahl-Hirschman Index (HHI), a measure of market concentration. That finding, coupled with the change in concentration that would be brought about by the acquisition, led the court to conclude that the acquisition should be presumed to be illegal. Notably, the court indicated that it would reach the same conclusion using either “the long accepted 2010 Merger Guidelines” or “the new 2023 Merger Guidelines” with their lower HHI thresholds.

Rebuttal: predictive value of market concentration statistics is undermined by “failing company” defense

The court went on to determine that the defendants “will likely be successful in rebutting the FTC’s prima facie case” by showing that the concentration figures “inaccurately predict[] the merger’s probable effect on competition.” The court wrote that “this is the ‘rare case’” where “bona fide economic difficulties . . . are so existential” that they “establish that the entity being acquired will no longer be a viable competitor in the absence of the proposed transaction” and therefore “an otherwise unlawful loss of competition” is justified. This is so even though in a later part of its opinion, the court “accept[ed] that the reimbursement rates paid by insurers at” the two facilities to be acquired “are likely to rise substantially after those hospitals are integrated into Novant’s insurance contracts.”

The court cited the following in favor of the defendants:

- There is “clear evidence” that the Davis facility would close absent the acquisition and, as to the Lake Norman facility, “the future competitive landscape . . . suggests that the hospital will not be able to sustain its current level of competition” and that its “competitive position will further erode to the point where it will most likely close in the foreseeable future, fully eliminating it as a competitor.”

- The economic state of the Lake Norman facility was due in part to management “decisions to close lines of service and [to] decline to make additional investments,” but these “decisions are not a litigation-related strategy or an attempt to artificially create economic woes to justify a profitable sale.”

- There were “no other bidders for” the facilities “despite reasonable attempts to sell the hospitals to others.”

- “Novant will . . . replace the lost lines of service and otherwise reinvigorate and support the [Lake Norman facility] and its staff” and “put Novant in a stronger competitive position” vis-à-vis the other major hospital operator in the region.

The court then went on to “weigh the ‘public equities’ to determine whether it is in the public interest to allow Novant to buy” the two hospitals before the conclusion of the FTC’s administrative proceeding. The court agreed with the FTC on one point: that the “loss of tax revenue” occasioned by the facilities’ change from for-profit to not-for-profit entities “weighs in favor of an injunction.”

However, the court concluded that several factors weighed against an injunction, including:

- “immediate competitive harm” was not likely absent an injunction because Novant “committed (in testimony believed and credited by the Court) that it will not directly or indirectly increase prices at [the facilities to be acquired] for three years”;

- “there was no evidence presented that it would be any harder to sell [the facilities to be acquired] than it would be currently if a divestiture were later ordered” (the court suggested that “it seems reasonable that a sale might be easier if Novant improves the hospital as it has promised”);

- “keeping Davis open is clearly in the public interest because its closure would eliminate critically needed inpatient psychiatric services”; and

- “Novant has committed to restoring medical services, adding staff, raising salaries, and making investments in equipment and infrastructure at [the Lake Norman facility] that will benefit patients and medical providers.”

Significance

The court’s decision is significant because it is an example of a “rare case” where a “failing firm” defense was successful in defeating a request for a merger injunction. The decision is also notable because it suggests that some courts may have a slightly less rigid view of the circumstances in which a defense is appropriate.

The FTC and DOJ Merger Guidelines – like the superseded Horizontal Merger Guidelines – discuss how the agencies evaluate “failing firm” claims. According to the agencies, the “defense applies when the assets to be acquired would imminently cease playing a competitive role in the market even absent the merger.” Citing U.S. Supreme Court opinions in *Citizen Publishing Co.* v. *United States*, 394 U.S. 131 (1969) and *United States* v. *General Dynamics Corp.*, 415 U.S. 486 (1974), the agencies look for evidence to satisfy three requirements: (1) a “grave probability of a business failure,” e.g., that the “allegedly failing firm would be unable to meet its financial obligations in the near future”; (2) “dim or nonexistent” prospects for reorganization, e.g., that the “failing firm would be unable to reorganize successfully under Chapter 11”; and (3) evidence that the acquirer “is the only available purchaser.”

The agencies will look at “the firm’s actual attempts to resolve its debt with creditors” and for evidence that the firm “has made unsuccessful good-faith efforts to elicit reasonable alternative offers that pose a less severe danger to competition than does the proposed merger.” In a footnote, the agencies state that “parties must solicit reasonable alternative offers before claiming that the business is failing,” that “any offer to purchase the assets of the failing firm for a price above liquidation value of those assets will be regarded as a reasonable alternative offer,” and that “if a reasonable alternative offer was rejected, the parties cannot claim that the business is failing.”

Another footnote describes how the agencies evaluate “claims that the assets of a division would exit the relevant market in the near future.” Here, the agencies generally require the parties to use “cost allocation rules that reflect true economic costs” to show “the division has a persistently negative cash flow on an operating basis” that is “not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill.” The agencies also require evidence that “[the] owner of the failing division has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its assets in the relevant market and pose a less severe danger to competition than does the proposed acquisition.”

The court appears to have evaluated the defendants’ failing firm defense mostly in line with the merger guidelines. For example, the court found that “[i]f this transaction is enjoined, CHS plans to close Davis immediately”; “CHS is in a difficult financial situation”; and despite soliciting four offers for the Lake Norman facility, other than Novant, “none submitted an offer, at any price.” However, the court also found that “[i]n the absence of a sale, there is no reason to believe that CHS will do anything other than continue to operate [the Lake Norman facility] with very limited investments”; and “CHS will continue to allocate funds towards required maintenance of the facility, but will not allocate any meaningful growth capital.” To be sure, the court concluded that the Lake Norman facility would “most likely close in the foreseeable future.” But the merger guidelines speak of “imminen[ce]” and “the near future.” (Though intuitively, one could see how it is likely prudent for a company to not wait until the brink of collapse before selling itself.)

Furthermore, the court’s decision also does not contain a clear indication that it determined that the CHS facilities had “dim or nonexistent” prospects for reorganization through bankruptcy proceedings or otherwise, or that there were “actual attempts to resolve . . . debt with creditors.” By contrast, the court found that “[b]ecause of its debt, CHS has engaged in an ongoing effort to sell (or close) many of its hospitals” while “prioritiz[ing] investments in regions where it has a network of facilities and healthcare providers.” And to the extent that the facilities to be sold are “divisions” of CHS, the court appears only to have found that “CHS [as a whole] does not generate enough cash flow to cover its costs” rather than finding that the divisions themselves have “persistently negative cash flow.” The court’s acceptance of the defense here could suggest that while courts will by and large hew closely to the merger guidelines, in some circumstances – for example a reorganization involving the sale or shuttering of some facilities – defendants need not rigidly adhere to each and every purported element of the defense stated in the guidelines.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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