Proskauer

FTC Focus: Private Equity Investments In Healthcare

Law360 on **August 1, 2024**

This article is part of a monthly column that considers the significance of recent Federal Trade Commission announcements about antitrust issues. In this installment, we discuss the agency's increased scrutiny of private equity investments in healthcare.

U.S. antitrust regulators, particularly the Federal Trade Commission, have been stepping up scrutiny of private equity investments in healthcare.

On March 5, the FTC, along with the U.S. Department of Justice and the U.S. Department of Health and Human Services, issued a joint request for public comment on consolidation in healthcare markets, citing concerns that PE "transactions may lead to maximizing profits at the expense of quality care."

Concurrently, the FTC hosted a workshop on the topic, featuring panels filled with critics of PE investments. Absent were voices from those directly involved in PE investments or those affiliated with PE sponsors. How concerned should PE funds, dealmakers and practitioners be? The answer may surprise you.

At the workshop, FTC Chair Lina Khan identified three practices in PE healthcare investments to be particularly concerning:

- Rollup acquisitions where PE firms consolidate a market through a series of smaller transactions;
- The so-called flip-and-strip approach, where PE firms use large amounts of debt to acquire companies with the alleged goal of quickly increasing profits to resell at a premium; and
- Minority investments in rival providers, which potentially can undermine incentives to compete.

But if these practices aren't illegal, then on what antitrust or other grounds could the FTC challenge these practices?

Rollup Acquisitions

In September 2023, the FTC made history with its first challenge against a private equity purchase of medical practices, suing one of the nation's largest anesthesiology groups and a private equity firm in FTC v. U.S. Anesthesia Partners Inc., saying it put "the market on notice."

This lawsuit targets a rollup strategy where a purchaser, often backed by a private equity sponsor, acquires multiple smaller companies in the same sector.

On May 13, 2024, a judge in the U.S. District Court for the Southern District of Texas granted the PE firm's motion to dismiss. The court found that certain conduct by the PE firm did not violate antitrust laws, including:

- Receiving profits from investments in a healthcare company;
- Holding minority interests in a healthcare company;
- Participating in acquisition strategies;
- Assisting in identifying and analyzing prospective targets;
- Participating in the consolidation of certain markets; and
- Investing in other healthcare companies that also utilize roll-up acquisition

This is a significant win for PE investors, but the FTC may still seek injunctive relief under Section 13(b) or bring an internal agency action under Section 5 of the FTC Act even if antitrust claims are unavailable.

In U.S. Anesthesia, the FTC's Section 13(b) claim was also dismissed against the PE firm. The court acknowledged certain prior cases against parent companies, but distinguished them because the parent companies there had majority ownership interest of 95% to 100%, compared to the PE firm's 23% minority stake in the anesthesiology group.

The court did not address what ownership threshold would be sufficient to assert a claim against a parent company or PE firm, but 23%, at least, was not enough.

Finally, while not present in this case, the FTC can bring an internal agency action under Section 5 to challenge an "unfair or deceptive act or practice in or affecting commerce."

Under the FTC's current policy, "a series of mergers, acquisitions, or joint ventures that tend to bring about the harms that the antitrust laws were designed to prevent but individually may not have violated" may constitute a violation of Section 5.

In other words, the FTC may take the position that a rollup strategy that does not violate the Sherman or Clayton Acts may still trigger Section 5 liability.

However, because the U.S. Supreme Court created new paths to challenge the constitutionality of the FTC's adjudication process with its April 2023 decision in Axon Enterprises v. FTC, the agency may be hesitant to rely on agency proceedings to bring such novel challenges.

Flip and Strip

The FTC has expressed concern that PE firms use large amounts of debt to acquire healthcare companies and engage in cost-saving practices including selling certain assets with the goal of quickly increasing profits so they can resell at a net gain.

At the March 5 workshop, Khan noted that "these short-term profit-exacting strategies can undercut long-term value" and have "life or death consequences" for patients. She also criticized the related practice of hospital sale-leasebacks, where the real estate under a hospital is sold, and the new owner leases it back to the hospital.

Such characterizations, however, fail to recognize that those investments often provide much-needed capital infusions when credit may not be readily available, allowing healthcare providers to invest in new technologies, expand facilities, and improve services or otherwise right faltering ships.

Absent fraud or other wrongful conduct, there has never been a law against stripping a company for parts or cash, even if that company is a hospital.

So, if the FTC is serious about going after such practices, the question remains: How does it plan to do so? Making decisions that harm one's competitiveness is not an antitrust violation. Nor is it clearly a Section 5 violation, an unfair or deceptive act under the FTC's reading.

That leaves premerger review. When interested in a transaction, the FTC will inquire through either informal or formal requests during the waiting period under the Hart-Scott- Rodino Act. Employment and data questions have already been added to the standard Second Request form that would likely capture cost-cutting measures. So, we can expect that healthcare related M&A activity that can be categorized as flip-and-strip will be scrutinized in the merger review process before the FTC.

Minority Investments

The FTC also highlights PE firms' practice — as part of critical capital movement and infusion — of acquiring minority stakes in rival firms within the same industry which may "soften firms' incentives to compete."

The theory is that such an ownership structure can incentivize firm managers to consider their common ownership interest in decisions about pricing, output and business strategy, thereby lessening competition in a market.

The FTC has had some recent success challenging interlocking directorates under Section 8 of the Clayton Act. Based on this record, expect to see similar Section 8 enforcement against interlocking directorates in healthcare, though successful Clayton Act Section 7 claims, that such ownership structures are likely to significantly reduce competition, will likely remain the exception.

What's Next?

Despite the novel grounds for challenging many of these practices, expect the FTC's scrutiny to continue through the end of this administration. Rather than wait for the antitrust regulators to investigate, PE sponsors and affiliates should take proactive measures to avoid and mitigate the cost of a potential investigation.

Identify potential investigatory targets.

The new merger guidelines establish certain thresholds that trigger presumptions that a transaction is anticompetitive. PE sponsors and practitioners should identify potential markets where the 30% threshold may be triggered, identify counterarguments to market definitions that result in such share calculations, and carefully consider the risks and costs associated with an investigation before making any additional transactions. Even smaller transactions that would not meaningfully increase market shares may lead to an investigation under the new guidelines.

Establish clear boundaries between minority investments.

PE sponsors should review investments they may have with multiple providers in competing markets to identify relationships that could draw regulators' ire. Again, the merger guidelines provide some insights.

The guidelines flag both cross-ownership, or holding a noncontrolling interest in a competitor, and common ownership, or when individual investors hold noncontrolling interests in firms that have a competitive relationship, as problematic.

PE sponsors should identify where these relationships exist and consider if steps to mitigate risk are necessary — including stepping off boards where Clayton Act Section 8 may be implicated.

Tout the benefits of PE investments.

Private equity provides much-needed capital infusions, offering financial stability and allowing healthcare providers to invest in new technologies, expand facilities, and improve services and offerings.

Moreover, PE investors, with their deep industry knowledge and experience, often bring management expertise and operational efficiencies, leading to streamlined operations and reduced waste, which enables healthcare providers to operate more effectively and competitively.

The best defense is a good offense, and incorporating these points into initial deal documents where appropriate can build a strong evidentiary foundation if, or when, the FTC investigates.

Reproduced with permission. Originally published July 31, 2024, "FTC Focus: Private Equity Investments In Healthcare," *Law360*.

Related Professionals

- **David A. Munkittrick**
  Partner
- **John R. Ingrassia**
  Partner
- **Timothy E. Burroughs**
  Associate