Private Equity Faces Increased Antitrust Scrutiny as DOJ, FTC Crack Down on Common Practices

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Key Takeaways: After years of signaling their intent, the Federal Trade Commission (the "FTC") and the Department of Justice (the "DOJ") (collectively, the "Agencies") have begun to make good on their promises to more heavily regulate private equity ("PE") transactions. Long a priority of the Agencies, they have now begun to legally challenge many practices common amongst private equity firms. A recent example of this is FTC v. U.S. Anesthesia Partners, Inc., where the FTC is challenging a PE firm's roll-up strategy by arguing violations of the Sherman Act, the Clayton Act, and the FTC Act. However, this example is likely foreshadowing further action against other aspects of the PE business model. Accordingly, PE firms should proceed with caution.

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Background: The Agencies Have Long Been Seeking to Challenge PE Business Practices

Historically, PE investment was seen as short-term, transitory, and unlikely to affect competition. However, Former FTC Commissioner Rohit Chopra signaled a change in perspective when he remarked in 2020 that the FTC should more closely examine PE transactions, especially non-reportable transactions. Current FTC Chair Lina Khan's 2021 memo stated that "...the growing role of private equity... may facilitate unfair methods of competition and consumer protection violations. Khan reiterated this statement the following year, noting that "antitrust enforcers" should scrutinize how PE strategies

"distort incentives… and hinder competition." These are just a sample of many statements and publications made by agency leaders over recent years, all foreshadowing a change in approach to enforcement when it comes to PE.

Roll-Ups

A staple of PE investment is the roll-up strategy wherein a PE firm purchases a platform company, followed by purchases of smaller "bolt-on" companies in adjacent geographies or industry verticals. The firm then integrates the bolt-ons into the platform, which generates synergies, efficiencies and organic growth. For the PE investor, this strategy can, in turn, lead to larger returns on investment upon sale of the consolidated business. The agencies have signaled several concerns with this strategy, namely, that they are unable to fully review the underlying transactions because the entities in question often are too small to trigger Hart-Scott-Rodino Act ("HSR") review.

Interlocking Directorates

An interlocking directorate occurs where a company's board member simultaneously serves as the board member of another competing company. The two companies would then be said to have an "interlocking directorate". Because PE firms seek to improve the management of their portfolio companies, they often appoint representatives to serve as board members of these companies; while it would be uncommon for one PE group to invest in two direct , the Agencies often view PE targets as competitors even when their businesses have indirect or partial competitive overlaps. These targets then come to have interlocking directorates. An interlocking directorate is "direct" where the same representative sits on multiple boards, and it is "indirect" when multiple representatives of the same PE firm sit on multiple boards.

Depending on the circumstances, interlocking directorates could be *per se* violations of the Clayton Act, Section 8. PE firms are at a heightened risk of violating Section 8 because they tend to fill board seats on a large number of portfolio companies. Last year, we published an article about enforcement against interlocking directorates in the PE space, highlighting that the Agencies are increasingly targeting Section 8 violations by PE firms.

Where We're at Now: The Agencies Intensify Enforcement Efforts

Roll-Ups

The most recent activity on roll-ups is the FTC's action against U.S. Anesthesia Partners and the PE firm Welsh Carson. The FTC's court filings paint a critical picture of the roll-up strategy, and its objection to the practice in general: "…USAP and Welsh Carson engaged in what they

referred to as a "roll-up," buying nearly every large anesthesia practice in Texas... All told, USAP's roll-up scheme involved over a dozen practices." The FTC is seeking various remedies which could include divestitures of portions of the business. Even if the ultimate remedy is short of divestiture, all of the remedies sought by the FTC could put constraints on the operation of the business and threaten to on the investments.

In particular, the FTC takes issue with the following features of Welsh Carson's roll-up:

- The resulting entity controlled around 43% of Texas's hospital-only anesthesia cases, with higher shares in local markets.
- The use of illegal price-setting and market allocation agreements.
- The leveraging of anticompetitive conduct to achieve large price increases.

Another current example of the agencies' crackdown on roll-ups can be seen in the pressure they put on PE firm Thoma Bravo in its acquisition of ForgeRock. Many of Bravo's portfolio companies operate in the software industry. Having been involved in a roll-up of identity and access management ("IAM") software companies, Thoma Bravo sought to purchase ForgeRock, another company in the IAM space.

A third example is when the FTC obtained a consent order against PE firm JAB Consumer Partners to halt its roll-up of veterinary services clinics. JAB had been engaged in a roll-up of clinics across the country, where it would consolidate them under one of two parent companies. Following JAB's announcement of an acquisition of a separate veterinary clinic parent company, the FTC intervened to halt the deal, and eventually investigated its prior roll-up activities. Following the investigation, the FTC obtained a consent order against JAB, requiring it to divest its holdings in various markets and to obtain FTC approval before making future acquisitions in the veterinary services clinics industry.

Interlocking Directorates

Last October, the DOJ forced the resignation of seven individuals from five companies due to interlocking directorates. One director, a representative of Thoma Bravo, was shared by Solarwinds Corp and Dynatrace, Inc. Thoma Bravo also had two additional board seats on Solarwinds. All three of Thoma Bravo's director-representatives were forced to resign.

In August 2023, the FTC announced that it intervened against PE firm Quantum Energy Partners and its target, EQT Corporation, by obtaining a consent order that, in addition to requiring divestment and the breakup of a joint venture, also prohibited the firm from occupying any of EQT's board seats. The FTC justified the consent order, stating that it prevents an interlocking directorate from occurring.

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Where We're Going Next: Proceeding with Caution

The Agencies' recently released proposed merger guidelines highlight aspects of the PE roll-up strategy that the Agencies take issue with. Specifically, the proposed guidelines provide that it is "presumptively anticompetitive" for an entity to attain a market share of as low as 30% in a given market. The Agencies define markets geographically and by product or service. Given that the Agencies often define geographic markets as cities or even parts of cities, the merger guidelines imply that the agencies view many roll-up strategies as presumptively anticompetitive. For example, while a PE firm may view its roll-up of entities within a midsize city as being inconsequential to the overall industry, the FTC may view it as having anticompetitive effects on that city in particular.

The same is true for product markets, which are often defined narrowly based on the particular qualities of a PE portfolio company's products or services. For example, in the Welsh Carson case, the FTC has defined the relevant product market to be "commercially insured hospital-only anesthesia services", rather than all anesthesia services. The result of this is that the FTC may view a PE firm's market share as much higher than the PE firm itself views it.

The recently-announced proposed changes to the HSR filing rules are further evidence of this trend, and seem designed, in many respects, to further the Agencies' interest in cracking down on the PE sector. For example, HSR filers under the new rules would be required to provide detailed information regarding board membership. The primary purpose of this requirement appears to be to allow the Agencies to more easily pursue interlocking directorates and other activities of PE funds.

It appears clear that additional regulatory headwinds will continue to strengthen against the PE sector. Industry participants should be disciplined and thoughtful when making operational decisions, drafting internal documents, and engaging in M&A activity, especially when such activities involve roll-ups and interlocking directorates. Koley Jessen's team of private equity lawyers continues to be available to assist PE clients in navigating antitrust risk and interactions with the Agencies. We encourage current or prospective clients to contact us to further discuss these issues.