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Considerations For Private Equity After FTC Vet Clinic Deal

By **Michael Murray, Michael Wise and Noah Pinegar** (July 7, 2022, 5:44 PM EDT)

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Private equity firms should take special note of the Federal Trade Commission's recent consent decree in a deal combining two veterinary service providers, because it may be a bellwether of things to come.

While requiring a buyer to divest assets in overlapping jurisdictions by itself is nothing particularly novel, the scope of the ancillary provisions in the consent decree, combined with the commission's statement accompanying the release, suggests increased risk for private equity investment strategies and a punitive approach to deals requiring any remedial action.

With these concerns in mind, there are several practical steps that private equity investors should consider to protect against unwelcome antitrust regulator interest.

The Consent Decree

On June 13, the FTC conditionally approved a $1.1 billion merger between two competing pet care and pet health services, Compassion-First Pet Hospitals and National Veterinary Associates Inc., owned by JAB Consumer Partners SCA SICA, and SAGE Veterinary Partners LLC.

The deal seeks to combine under JAB's control nearly 100 specialty and emergency clinics throughout the country, including in three local markets where the FTC determined the deal may substantially lessen competition: Austin, Texas; San Francisco; and the East Bay Area, California.

The FTC's approval is conditioned upon successful implementation of the executed consent agreement,[1] which requires JAB to, among other related provisions:

- Divest six veterinary clinics in the aforementioned local markets;
- Obtain the FTC's prior approval for future acquisitions of specialty or emergency veterinary clinics within 25 miles of an existing JAB clinic anywhere in California or Texas for the next 10 years; and
- Provide 30-day advance written notice to the FTC before JAB attempts to acquire a specialty or emergency veterinary clinic within 25 miles of a JAB clinic anywhere in the U.S. that JAB owns now or in the future, for the next 10 years.

In addition, the divestiture buyer must obtain prior approval from the FTC before transferring any of the divested facilities to another buyer for 10 years.

Of particular note is the 30-day, nationwide advance notice requirement. The FTC described the geographical breadth of that provision as "the first of its kind in a Commission order," noting that JAB has "repeatedly proposed acquisitions that the Commission has had reason to believe would violate the antitrust laws."

Such a provision, according to the FTC, is necessary to allow enforcers to establish "key safeguards against future dealmaking" that may prove unlawful, rather than merely addressing the allegedly unlawful aspects of the specific acquisition through divestiture. This requirement is intended to curtail JAB's ability to acquire smaller veterinary businesses that would otherwise fall below the Hart-Scott-Rodino reporting threshold.

Even more noteworthy is what the FTC signaled outside of formal documents. In public statements,[2] Chair Lina Khan and Commissioners Rebecca Kelly Slaughter and Alvaro Bedoya appeared to identify a heightened risk of anti-competitive conduct endemic to the merger and acquisition activity of private equity firms.

According to their statement, antitrust enforcers must be attentive to the inclination of private equity business models to "in some instances distort incentives in ways that strip productive capacity, degrade the quality of goods and services, and hinder competition."

The Democratic commissioners cited what they saw as a harmful private equity playbook, which "undermine[s] long-term health and competitive viability" of acquisition targets through tactics like leveraged buyouts, which "saddle businesses with debt and shift the burden of financial risk."

The commissioners further emphasized private equity's recurrent focus on short-term margins as incentivizing "unfair or deceptive practices and the hollowing out of productive capacity," as well as the "buy-and-buy" business model that allows firms to "roll up sectors," "accrue market power," and "reduce incentives to compete."

As pointed out by Republican Commissioners Noah Joshua Phillips and Christine Wilson, neither the complaint[3] nor the analysis to aid public comment[4] accompanying the settlement raised any issues particular to private equity firms.

While both Republican commissioners joined the FTC decision, they denounced their colleagues' "rhetoric unrelated to competition" and cautioned that "[i]mposing heightened legal obligations on disfavored groups — including private equity — because of who they are rather than what they have done raises rule of law concerns."

There are at least two key takeaways from the consent decree and accompanying statements for other private equity firms. First, the FTC has staked out a position in opposition to private equity roll-ups of smaller players, which in many cases are made up of deals falling below HSR notification thresholds until the investment is exited.

This strategy seems likely to draw increased scrutiny going forward, including at least the potential for scrutiny of nonreportable deals.

Second, the FTC is seeking not merely to remedy anti-competitive combinations in the instant deal, but to use consent decree provisions as arguably punitive measures intended to chill future deals that have not yet been contemplated.

Consent Decree in Broader Agency Enforcement Context

The settlement between JAB and Sage settlement is emblematic of a broader shift in agency priorities under the Biden administration.

Leadership at the FTC and U.S. Department of Justice Antitrust Division have repeatedly called for increased scrutiny of private equity-driven mergers and acquisitions, ranging from past roll-ups to questioning incentives of companies to compete when they may have common investors or be owned by affiliated funds.

These concerns appear to stand in stark contrast to treatment of private equity under the last administration, where deals with no horizontal or vertical dimension were rarely scrutinized and antitrust agency leaders recognized private equity incentives often aligned with antitrust enforcement.

Current enforcers' views on private equity transactions seem to be coming out in a variety of ways. One of the first major changes to come from the FTC at the beginning of the Biden administration was the suspension of early termination of HSR waiting periods for nonproblematic transactions — something that would seem to disproportionately impact private equity firms that engage in a large volume of merger and acquisition activity that does not implicate competitive concerns.

The moratorium was announced in February 2021, and despite the FTC's press release stating that it would be brief, there are no indications that early termination will be returning soon.

More recently, agency distaste for private equity has been voiced more directly.

For example, in a recent speech to a health care antitrust conference, Andrew Forman, deputy assistant attorney general for the U.S. Department of Justice Antitrust Division expressed concerns that "certain private equity transactions and conduct suggest an undue focus on short-term profits and aggressive cost-cutting."

Forman further noted that when evaluating divestitures to resolve problematic mergers, the DOJ should "look ... more favorably on a market participant as a buyer of assets than a private equity firm."[5]

Just two years ago, the Antitrust Division merger remedies manual noted that in some situations a private equity buyer in divestiture situations may be preferable due to flexibility in investment strategy, commitment to the divestiture, willingness to invest when needed, and bringing relevant experience to the company.[6]

The FTC's comments have been even more pointed. In June, Khan suggested blaming private equity for an increase in the mortality rate observed in nursing homes after being acquired by a private equity firm.[7]

Similarly, FTC commissioners have also cited reports to suggest that private equity's focus on short-term profits in the broader health care context may "reduce quality of care, increase costs for patients and payors, and generate appalling patient outcomes."[8]

Meanwhile, the agency is actively searching for issues with private equity transactions. An FTC blog post in September 2021 noted that in-depth second request investigations may include examination of "how the involvement of investment firms may affect market incentives to compete,"[9] and there are indications that some investigations are being directed entirely at this issue, rather than traditional competition concerns.

Practical Implications

The current enforcement environment is one in which private equity firms need to be increasingly aware of the potential for antitrust to delay or stymie their deals. There are five key takeaways to be aware of.

First, the agency aggressiveness signals that delays for private equity deals will increase. We can expect to see heightened focus on portfolio companies in adjacent spaces or upstream or downstream from an acquisition target.

Parties should also anticipate greater focus on minority investments and other cross-ownership issues that current regulators believe dampen competitive incentives. At the margins, these concerns will generate in-depth antitrust reviews in transactions that would have been cleared without significant issues in recent years.

With that in mind, careful attention to merger agreement drafting, including around risk shifting, conditions precedent and end dates, is crucial to prepare for potential antitrust pushback.

Second, iterative investment strategies seem likely to draw increased scrutiny. Roll-ups of smaller players within a given industry are common in the private equity space, with buyers looking to create a larger platform to spin off at the end of an investment cycle.

The JAB/Sage consent decree makes it clear that the FTC is taking a hard look at these roll-ups, and may also look to hamper the strategy by imposing prior approval requirements going forward. Notifiable transactions that are part of a roll-up strategy are incrementally more likely to face antitrust scrutiny. Private equity firms should also be aware that when exiting an investment, a strategic sale may face increased risks for delay and intervention that outweigh the potential price premium that might be otherwise obtainable.

Third, prior approval requirements present a palpable risk for private equity buyers. Historically, parties could enter into a deal knowing that they might need to divest some overlapping business to remedy any potential competitive harm, but otherwise proceed with their operations going forward.

The prior approval requirement, as seen in the JAB/Sage consent decree, complicates this by imposing an additional 10-year regulatory burden with unforeseeable consequences, particularly for a private equity fund that engages in frequent M&A activity. In this sense, a merger agreement provision requiring the buyer to potentially divest assets may carry with it significantly more risk than before.

Fourth, messaging to the public and the agencies remains an essential component of the HSR review process. It will be increasingly important to demonstrate a firm's commitment to maximizing its returns, such as by acquiring and improving businesses, including showing the firm's record of success in comparable situations, and a capital structure that will preserve the target business's competitive position pre-merger. As one senator recently noted, the agencies appear to be taking a "guilty-until-proven-innocent approach to law enforcement," and savvy investors may look to create a consistent record showing pro-competitive factors, even before a deal comes under HSR scrutiny.

Fifth and finally, private equity firms can expect to face headwinds if they endeavor to buy assets that the antitrust agencies require merging parties to divest in order to survive merger review.

The agencies seem to be returning to their skepticism that private equity firms have similar incentives to operate divested assets in a way that maintains competition at pre-transaction levels. That means that private equity firms are less likely to be approved as divestiture buyers. It also means that private equity firms may be less likely out of the gate to earn the merging parties' support as a divestiture buyer, all other terms being equal.

And perhaps most notably, the decadelong requirement to obtain prior approval before selling any assets acquired as part of the divestiture package may not sit well with private equity buyers.

These factors may all be worthy of consideration before seeking to bid on a divestiture package under the current administration.

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[1] Order to Maintain Assets, In the Matter of JAB Consumer Fund/SAGE Veterinary Partners, Commission File No. 2110140, Federal Trade Commission (June 13, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766NVASAGEOMA.pdf; Agreement Containing Consent Orders, In the Matter of JAB Consumer Fund/SAGE Veterinary Partners, Commission File No. 2110140, Federal Trade Commission (June 13, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766NVASAGEACCO.pdf.

[2] Statement of Chair Lina M. Khan Joined by Commissioner Rebecca Kelly Slaughter and Commissioner Alvaro M. Bedoya in the Matter of JAB Consumer Fund/SAGE Veterinary Partners, Commission File No. 2110140, Federal Trade Commission (June 13, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766KhanStatement.pdf.

[3] Complaint, In the Matter of JAB Consumer Partners, National Veterinary Associates, and SAGE Veterinary Partners, Commission File No. 2110140, Docket No. C-4766 (June 3, 2022) (Redacted Public Version), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766NVASAGEComplaintPublic.pdf.

[4] Analysis To Aid Public Comment, In the Matter of JAB Consumer Partners, National Veterinary Associates, and SAGE Veterinary Partners, Commission File No. 2110140, Federal Trade Commission (June 13, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766NVASAGEAAPC.pdf.

[5] Dep. Asst. Atty. Gen'l Andrew Forman, The Importance of Vigorous Antitrust Enforcement in Health Care (June 3, 2022), https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-andrew-forman-delivers-keynote-abas-antitrust#:~:text=That%20is%20precisely%20why%20we%20must%20aggressively%20enforce,care%2C%20additional%20lifesaving%20innovations%2C% paying%20jobs.

[6] U.S. DOJ Antitrust Division, Merger Remedies Manual (Sept. 2020), https://www.justice.gov/atr/page/file/1312416/download.

[7] Lina Khan Vows 'Muscular' US Antitrust Approach on Private Equity Deals, FT.com (June 9, 2022), https://www.ft.com/content/ef9e4ce8-ab9a-45b3-ad91-7877f0e1c797.

[8] Statement of Chair Lina M. Khan Joined by Commissioner Rebecca Kelly Slaughter and Commissioner Alvaro M. Bedoya in the Matter of JAB Consumer Fund/SAGE Veterinary Partners, Commission File No. 2110140, U.S. Federal Trade Commission (June 13, 2022), https://www.ftc.gov/system/files/ftc_gov/pdf/2110140C4766KhanStatement.pdf.

[9] Holly Vedova, Making the Second Request Process Both More Streamlined and More Rigorous During this Unprecedented Merger Wave, Federal Trade Commission (Sept. 28, 2021), https://www.ftc.gov/enforcement/competition-matters/2021/09/making-second-request-process-both-more-streamlined-more-rigorous-during-unprecedented-merger-wave.

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