CAPSTONE

Private Equity's Healthcare Problem:

The Coming Investigations into Vertical and Horizontal Integration

The bottom line

Capstone believes investigations by the federal and state governments into vertical and horizontal integration and private equity in healthcare will gather momentum, with efforts at the state level posing more of a threat to private and public healthcare companies than those at the federal level. In this report tracking this scrutiny, Capstone outlines the various ongoing investigations, the timelines, and the ramifications for the industry.

- Capstone believes scrutiny of private equity ownership and both vertical and horizontal integration in healthcare is increasing and will continue regardless of the outcome of the 2024 election. However, the election will impact the nature of some of the investigations. If President Biden is reelected, the federal government will maintain a tight focus on the issue, while a Trump win would lead several blue states to take the lead in regulating the industry. In either scenario, the scrutiny presents potential headwinds for large vertically integrated insurers, namely UnitedHealth Group Inc. (UNH) and CVS Health Corp. (CVS), and privately held provider roll-ups.

- The Biden administration has begun a series of investigations, legal challenges, and requests for information across provider, payor, and pharmacy subsectors of healthcare related to vertical and horizontal integration. We believe these recent efforts by the federal government are intended to have a cooling effect on the market. Levers for actual reform in vertical integration are relatively limited, and we do not necessarily think that antitrust enforcers can (or believe they can) win the cases they are bringing in court.

- Capstone continues to believe the greatest risk from regulators is in the states, where action generally falls into three categories: 1) reporting and transparency requirements; 2) attorney general (AG) authority to block transactions, and 3) prohibition of non-competes. California's ongoing attempt to fully block private equity transactions in healthcare in the state is the most recent example of a shift away from transparency and notice requirements that historically have been benign into material regulatory changes.

A Deeper Look

Private Equity Ownership

STATE-LEVEL ACTIONS HEAT UP, POSE GREATEST THREAT

Capstone believes risks are highest at the state level. Most of the relevant bills apply to mergers and acquisitions and often specify that at least one party in the transaction must be a "healthcare entity," though exact state definitions of that term vary. In North Carolina, a bill passed that specifically focused on hospital consolidation, while a similarly specific bill in Washington state fell short of becoming law.

Notably, most state-level transactions so far have explicitly targeted physician practice management (PPM) roll-ups rather than back-end vendors serving healthcare providers. Importantly, this legislation falls into two categories: (1) bills requiring notice of a transaction to a state authority and (2) bills requiring notice of and *approval of* the transaction by that state authority. The second is more far-reaching, given that a requirement for explicit approval by the state AG adds an additional regulatory step to the transaction process and gives states a chance to block transactions.

While Illinois, New York, and Indiana have only required the notice in their legislation, in California, there has been a proposal to go a step further in the recently proposed Assembly bill, AB 3129, which also requires *written consent* from the attorney general's office for a transaction to go through. The same Assembly member who created the Office of Health Care

Affordability (OHCA) in California, Jim Wood (D), is spearheading efforts toward passing AB 3129. Required notices of transactions in California are now filed with OHCA; AB 3129 builds upon these efforts by requiring the approval of the attorney general for any transactions. Assembly member Wood is well-liked in the state assembly and recently announced he will not seek reelection in 2024. Capstone expects Wood to use any momentum created by the announcement of his retirement to push for passage of AB 3129 as a legacy policy.

We have also seen momentum to restrict noncompete agreements, which have been historically used to limit competition and the sharing of sensitive information between competitors. California's AB 3129 builds upon this momentum to specifically prohibit contractual provisions such as non-competes and non-disparagement clauses. On a broader level, on April 23, 2024, the FTC announced a ban on noncompetes, finalizing a rule that was proposed last January. The rule does not apply to certain senior-level executives whose noncompete agreements existed prior to the effective date (120 days following the rule). The rule also contains a "sale-of-business exception" for noncompetes entered relating to the sale of a business.

While California is often on its own in terms of aggressive healthcare policy, several other states are also creating challenges for PE ownership. Although most of the action has expectedly been in blue, or more liberal states—New York, Illinois, California—we have also seen movement in more red, conservative states, such as North Carolina and Indiana.

EXHIBIT 1:

Tracker of PE Transaction-focused Legislation or Regulation (Federal and State), Listed from Most to Least Far-Reaching

State	Bill/Law	Status	Timing	Type	Materiality Threshold and Description
(Federal)	Draft	Pending	-	-	Establishes a licensure requirement to invest in healthcare-related entities. A denial of licensure would require immediate divestiture in all healthcare-related companies. HHS could additionally block any deal, independent of licensure, while it continues to evaluate the impact of PE ownership in healthcare. Otherwise, the bill establishes additional broad financial and outcome reporting requirements.
California	AB 3129	Introduced; at Committee on Judiciary	90 days pre-closing	Notice and Approval	Requires all private equity transactions to submit notice *and* also obtain written *consent* (or approval) from the state AG for any private equity and/or hedge fund acquisition of health care entities. Imposes prohibitions on certain contractual provisions such as non-competes and non-disparagement clauses. The requirement would apply to any "material change transactions" where the transaction likely increases annual CA-derived revenue of either party by $10 million.
North Carolina	SB 16	Introduced; at Senate Rules	90 days pre-closing	Notice and Approval	Establishes a requirement of written notice and approval regarding any hospital merger/ transaction and the requirement for a public hearing (in the county of the merging parties). This is aimed at allowing the local community to share their perspective.
Minnesota	HF 4206 (and SF 4392)	Introduced; at House Commerce, Finance and Policy		-	Prohibits private equity companies or real estate investment trusts (REITs) from increasing or gaining new ownership in a provider group. HF 402, which passed the legislature in 2023, requires that the Commissioner of Health be notified of transactions between $10 million and $80 million in average revenue. These notice requirements
Indiana	SB 09	Signed into law, takes effect 7/1/2024	90 days pre-closing	Notice	Mandates that healthcare entities and private equity firms *notify* the state AG of certain transactions. The requirement applies when at least of the transaction companies is a healthcare entity, and at least one has $10 million or more in assets.

State	Bill/Law	Status	Timing	Type	Materiality Threshold and Description
Illinois	HB 2222	Took effect 1/1/2024	30 days pre-closing	Notice	This bill amends the state's Antitrust Act, instituting a requirement of notice of any merger, acquisition, or contract between any healthcare entities to the state AG. The AG may then request additional information. Notice requirements apply for any proposed transaction that would produce at least $10 million in annual revenue from Illinois residents.
New York	New York Public Health Law Article 45	Took effect 8/1/23	30 days pre-closing	Notice	Requires written notice to Department of Health regarding any material transactions in healthcare. Notably, *approval* authority was also included in Governor Hochul's proposed budget but not in the finalized version. The law includes any transactions that might prompt an increase in $25 million or more in revenue for the healthcare entity.
Oregon	HB 4130	Stalled	30-80 days pre-closing	-	Aimed at limiting corporate influence in medicine, places restrictions on physician practice management (PPM) by prohibiting certain non-professional businesses from owning or investing in health-related entities. These restrictions apply if at least one entity has an annual revenue exceeding $10 million nationally.
Washington	SB 5241 (and HB 1263)	Stalled	60 to 120 days pre-closing	Notice	Establishes a public review process targeted at hospital consolidation. The process, spearheaded by the attorney general's office, would require additional commentary by hospital, health systems, or providers – in the event of a merger or acquisition – regarding any impact to access of reproductive or gender-affirming care over the next 10 years. The requirement applies to transactions where an out-of-state entity produces $10 million or more in patient revenue annually from Washington residents.

Note: Within the exhibit, states are ranked from most to least far-reaching. More far-reaching legislation denotes more restrictive regulations that Capstone believes are more likely to be negative for investors and providers. Stalled bills are not included in the ranking.

Source: Wall Street Journal, Ropes and Gray, McGuire Woods, McDermott Will & Emery, Williams Mullen, Nixon Peabody

FEDERAL SCRUTINY INCREASES, THOUGH ACTION STILL LIMITED

While the attention paid to the impacts of private equity (PE) ownership in healthcare is growing, action continues to be limited. The HHS, DOJ, and FTC have launched a joint investigation into private equity in healthcare, which we believe will be broad and continue into the next administration. If Trump were to win back the White House, we instead believe the investigation would be discontinued or greatly softened, reducing the risk to sponsors. Notably, the investigations launch party, a working group held on March 5, 2024, hosted a series of patient advocates and providers, all with scathing reviews of PE ownership in healthcare.

Historically, the government's oversight of private equity in healthcare relied primarily on the FTC's evaluation of individual transactions for antitrust concerns under the Hart-Scott-Rodino Antitrust Improvement Act of 1976. These evaluations considered a transaction in isolation, rather than examining a history of transaction patterns.

This precedent changed in June 2022 when the FTC ordered a large private equity fund to divest a subset of veterinary clinics in California and Texas before continuing a merger with a competing clinic operator. Although the Biden administration first indicated its distaste for private equity ownership in its 2021 moratorium leading to an indefinite pause of early termination grants, this was the first public interference with the private equity industry.

Since then, the FTC has also expanded its antitrust purview into multiple transaction roll-ups, rather than relying on its historical single-transaction approach. The agency has also begun to implicate PE sponsors themselves, rather than portfolio companies alone.

In November 2023, CMS finalized a rule requiring nursing facilities to disclose ownership information following a series of reports tying declining standards of care during the COVID-19 pandemic to private equity ownership. Most recently, the Senate Health, Education, Labor, and Pensions (HELP) committee held a hearing to discuss the risks associated with PE ownership in healthcare. Capstone believes lawmakers will continue to increase scrutiny toward the private equity industry, although future action will depend on whether Democrats control the House, Senate, or White House.

EXHIBIT 2:

Pending Federal Investigations into Private Equity Ownership in Health Care

Department	Investigation/ Request	Start Date	Status	Description	Industries Impacted
Senate Homeland Security and Government Affairs Committee	Investigation into Private Equity Ownership of Emergency Departments	April 2024	Documents were due April 17, 2024	Broad investigation into the impact of private equity ownership on emergency physician staffing companies and related patient care. With increased focus on rural populations.	Emergency Physician Staffing Groups
HHS, DOJ, and FTC	Investigation of the Impact of Corporate Ownership Trend in Healthcare	February 2024	Comments were due May 2024	Request for public comments relating to the impact of increased consolidation and opaque contracting terms between GPOs and wholesalers.	Health Care Providers, Facilities, Ancillary Products and Services
Senate Budget Committee	Investigation into Private Equity Ownership of Hospitals	December 2023	Documents were due December 20, 2023	Broad investigation into the impact of private equity ownership of the quality of care in hospitals, with an increasing focus on negative outcomes.	Hospitals, Health Care Providers

Source: FTC, DOJ, HHS, Senate Budget Committee

Federal Integration Concerns Rising for Both Vertical and Horizontal Transactions

In the past, healthcare antitrust concerns have largely focused on horizontal integration as federal authorities have been unable to block large vertical transactions. While concerns about horizontal mergers remain, the Federal Trade Commission (FTC), contrary to its permissive position established in the early 2000s, has now reversed its outlook on vertical integration. Along with the Department of Justice (DOJ), Office of Inspector General (OIG), and the Center for Medicaid and Medicare Services (CMS), the FTC has launched a new wave of investigation into the impact of vertical integration on the broader US healthcare system.

Capstone has identified five active investigations into vertical integration in healthcare, spread across the Department of Health and Human Services (HHS), CMS, FTC, and DOJ. Many investigations are in the early stages and are likely to continue into the next administration.

Stakeholders continue to await the results of the FTC's 6(b) Investigation into Pharmacy Benefit Managers (PBM), which will likely inform the next steps of efforts at PBM reform. The FTC last updated the public in March 2024 that PBMs have yet to comply with orders to release documents, leading to delays in the investigation process. Capstone believes the FTC is likely to release the report before the end of President Biden's current term, allowing the Biden administration to tout it as a Democratic win.

By contrast, Republicans continue to resist and oppose FTC Chair Lina Kahn's expansive approach to antitrust, exemplified by a House Judiciary Committee exposé detailing dysfunction throughout the agency. It is unlikely that House Republicans would follow Chair Kahn's findings and data from the 6(b) PBM study and other investigations to inform policy recommendations. However, they would likely use findings and data to inform future policies.

If Trump were to win the election, Capstone believes many of the investigations would be softened or discontinued. By contrast, a second Biden term would increase momentum for investigating impacts of consolidation on health care, posing headwinds for large vertically integrated health companies.

Still, Capstone believes federal investigations into vertical integration are closer to smoke than fire. Healthcare consolidation is measured on the local level, making national remedies difficult to apply. For example, Capstone believes the most likely outcome of the DOJ's investigation into UnitedHealth Group is that local-level divestitures will be combined with more onerous federal reporting requirements for the insurer.

EXHIBIT 3:

Pending Federal Vertical Integration Investigations or Request in Healthcare

Department	Investigation/ Request	Start Date	Status	Description	Companies Impacted
HHS OIG	Audit of Vertically Integrated Medicare Part D Sponsors	Apr 2024	Expected 2026	Investigation of PBM impact on inflating Medicare drug prices.	UNH, CVS, CI, HUM
FTC and HHS	RFI into Lack of Competition and Contracting Practices Contributing to Drug Shortages	Feb 2024	Comments Due May 2024	Request for public comments relating to the impact of increased consolidation and opaque contracting terms between GPOs and wholesalers.	UNH, CVS, CI
CMS	Request for Information (RFI) into Medicare Advantage Vertical Consolidation	Jan 2024	Comments Due May 2024	Request for data, feedback, and recommendations on how to respond to vertical consolidation in MA.	UNH, CVS, CI, HUM, ELV, CNC, MOH
DOJ	UnitedHealth Antitrust Investigation	Jan 2024	Pending	Probe into vertical consolidation, especially between its insurance and provider (Optum) businesses and Medicare billing practices.	UNH
FTC	6(b) Investigation into PBMs	Jun 2022	Expected Late 2024 or Early 2025	Widespread study into PBMs and their impact on access and affordability of prescriptions.	UNH, CVS, CI, HUM, Prime Therapeutics, MedImpact

Source: FTC, DOJ, CMS, HHS, WSG, OIG

About Capstone

Capstone is a global, policy-driven strategy firm helping corporations and investors navigate the local, national, and international policy and regulatory landscape.

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We tailor our work to help our clients predict meaningful policy and regulatory backdrops, quantify their impact, and recommend strategies that unveil novel opportunities and avoid hidden risks.

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