NOTIFICATION AND ENFORCEMENT OF PE-BACKED CONSOLIDATION

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By Aslihan Asil & Thomas G. Wollmann

Private equity faces increasing scrutiny from antitrust authorities. Recently, the Federal Trade Commission sued a large financial sponsor and its portfolio company over a long series of acquisitions that allegedly consolidated Texas anesthesia markets and sharply raised prices. As the transactions span ten years, a natural question arises as to how they escaped enforcement for so long. Our answer is that the agency did not challenge the acquisitions in their incipiency because they were exempt from premerger notification. If we accept the government's claims, then this case reflects potential deficiencies in the Hart-Scott-Rodino Act and Rules, which establish and determine US reporting requirements. One problem is that exemptions depend on transaction size: acquisitions of small targets can have large economic consequences, resulting in stealth consolidation. The other problem is specific to private equity. When the investment structures commonly employed by financial sponsors are interpreted under the law, many transactions that would otherwise be reportable are instead exempt.

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I. INTRODUCTION

Antitrust authorities are more carefully scrutinizing private equity ("PE") investments. The leading example is a recent lawsuit filed by the Federal Trade Commission ("FTC"), which charges a large PE sponsor, Welsh, Carson, Anderson & Stowe, and its portfolio company, US Anesthesia Partners, with consolidating and monopolizing anesthesia markets in Texas.[2] According to the Complaint, the defendants systematically acquired nearly all major anesthesia practices in the state, which drove up prices and "cost Texans tens of millions of dollars more each year."[3] Borrowing a term coined by one of the authors of this article, Chair Lina Khan characterized the series of transactions as "stealth consolidation."[4]

One of the most striking aspects of the lawsuit is that it addresses transactions that are ten years old. This raises an obvious question as to how these deals evaded scrutiny for so long. Our answer lies with exemptions provided by the U.S. Premerger Notification Program, which is established and determined by the Hart-Scott-Rodino ("HSR") Act. Absent other practical means by which the agencies can discover transactions at their inception, escaping reporting requirements often equates to escaping antitrust scrutiny altogether.[5] We identify two channels through which the litigated transactions were mostly likely exempted.

First, only large transactions need to be reported to antitrust agencies. However, acquisitions of small targets often produce large changes in market structure, competition, price, and even quality. Since size poorly proxies for economic harm, size-based thresholds let anticompetitive deals go unenforced. This is especially problematic when PE sponsors employ "rollup" strategies, which focus on consolidating ownership through a long series of comparatively small transactions.

Second, even if a deal's value meets the reporting criteria, it might still be exempt from the Premerger Notification Program if it is backed by PE. Our recent work enumerates the ways in which this may occur. All boil down to how the Act and Rules treat "control," which is misaligned with economic reality.[6] When this misalignment meets with the investment structures commonly employed by PE sponsors, acquisitions that would otherwise require notification are instead exempt.

II. PREMERGER NOTIFICATION: HISTORY AND CONTOURS

Enforcing antitrust laws against anticompetitive mergers has proven to be challenging in the absence of premerger notification. Agencies find it difficult to discover mergers in their incipiency without the disclosures made under the Program. Without premerger notification, parties swiftly and discreetly merge their operations. By the time the federal government notices and opposes the merger, it is often too late — information has already been exchanged and assets are commingled. The post-merger unwinding process tends to be slow and expensive — akin to "unscrambling the eggs."[7] For instance, litigation that forced El Paso Natural Gas to divest Pacific Northwest Pipeline, which it acquired in 1957, lasted 17 years.[8]

To strengthen agencies' abilities to intervene in mergers in their incipiency, Congress passed the HSR Act in 1976. This legislation established the US Premerger Notification Program, requiring companies seeking to merge, unless explicitly exempted from the Act, to notify the

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2 Press Release, Fed. Trade Comm'n, FTC Challenges Private Equity Firm's Scheme to Suppress Competition in Anesthesiology Practices Across Texas, (Sept. 21, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/09/ftc-challenges-private-equity-firms-scheme-suppress-competition-anesthesiology-practices-across.

3 Complaint, *FTC v. US Anesthesia Partners, Inc.* (Sept. 21, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/2010031usapcomplaintpublic.pdf; *Id.*

4 Press Release, Fed. Trade Comm'n, FTC Challenges Private Equity Firm's Scheme to Suppress Competition in Anesthesiology Practices Across Texas, (Sept. 21, 2023), https://www.ftc.gov/news-events/news/press-releases/2023/09/ftc-challenges-private-equity-firms-scheme-suppress-competition-anesthesiology-practices-across ("The FTC will continue to scrutinize and challenge serial acquisitions, roll-ups, and other stealth consolidation schemes that unlawfully undermine fair competition and harm the American public."). *See* Thomas G. Wollmann, *Stealth Consolidation: Evidence from an Amendment to the Hart-Scott-Rodino Act*, 1 Am. Econ. Rev.: Insights 77, 79 (2019) [hereinafter Wollmann, *Stealth Consolidation*]; Thomas G. Wollmann, *How to Get Away with Merger: Stealth Consolidation and Its Effects on US Healthcare* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27274, 2020) [hereinafter Wollmann, *How to Get Away with Merger*].

5 John M. Barrios & Thomas G. Wollmann, *A New Era of Midnight Mergers: Antitrust Risk and Investor Disclosures* (Nat'l Bureau of Econ. Rsch., Working Paper No. 29655, 2022).

6 Aslihan Asil, John M. Barrios & Thomas G. Wollmann, Misaligned Measures of Control: Private Equity's Antitrust Loophole, 18 Va. L. & Bus. Rev. 51, 60 (2023) [Asil, Barrios & Wollmann, *Misaligned Measures of Control*].

7 H.R. Rep. No. 94-1373, at 8 (1976) ("'Unscrambling' the merger, and restoring the acquired firm to its former status as an independent competitor is difficult at best, and frequently impossible.").

8 *United States v. El Paso Nat. Gas Co.*, 376 US 651 (1964).

FTC and the DOJ in advance. This notification program provides agency personnel with crucial time to assess the competitive ramifications of transactions before the deals are finalized.

The Act applies to acquisitions of assets, voting securities in a corporation, or control over a non-corporate entity ("NCE"), such as a limited liability company or partnership. Notably, the Act's treatment of corporate and non-corporate entities differs. Acquisitions of non-corporate interests are reportable only when they confer control, whereas all acquisitions of interest in corporate entities are reportable if they meet the jurisdictional tests.[9]

The Act's jurisdictional tests consist of size-based criteria applied to both the transacting parties and the deal, commonly known as "size-of-transactions" ("SOT") and "size-of-persons" ("SOP") tests. At the present moment, assuming the target and acquirer have sufficient assets (or sales, in the case of manufacturing), the transaction is reportable only if its value is at least $119.5 million.[10] Moreover, if the target and acquirer fall short of the asset and/or sales test, then, the transaction is reportable only if the acquirer's interest in the target at the end of the deal is worth at least $478 million.[11]

To apply these jurisdictional tests, it is necessary to identify the acquirer and the target. Under the HSR Act, these parties may not directly participate in the transaction. Instead, the Act starts by identifying the entities directly involved in the transaction and traces "control" upwards until it reaches an entity not controlled by another, known as the "Ultimate Parent Entity" (UPE).[12] The jurisdictional thresholds then apply to these UPEs. In essence, interests are aggregated to the parent entities using "control," often defined as ownership of 50 percent of the entity's interests.[13]

III. STEALTH CONSOLIDATION

If small mergers were guaranteed to have unimportant effects on market structure and outcomes, then size-based tests may suffice to identify anticompetitive harm. However, in highly segmented industries, minor deals can have major effects on market structure, firm behavior, and ultimately consumer welfare.[14] For example, consider a merger among two competing healthcare providers in a concentrated rural or suburban market. The transaction might amount to only a few million dollars, falling far short of HSR size thresholds, but nonetheless create a monopoly or duopoly, greatly reducing incentives to set low prices or provide high quality care.

Recent work documents the scope of stealth consolidation and its real effects. The first piece of evidence originates from the 2001 amendment to the HSR Act, which abruptly raised the transaction value threshold from about $10 million to $50 million and caused a substantial shock to the program.[15] Following the amendment, there was an immediate 70 percent reduction in the total number of notifications received by the FTC and DOJ, and investigations into newly-exempt mergers fell by over 90 percent, suggesting that mergers falling outside the scope of the HSR Act underwent minimal, if any, antitrust scrutiny.16 Moreover, the horizontal market share of newly exempt mergers rose after the amendment, consistent with the antitrust law's deterrence effect (i.e. knowing that they would receive limited scrutiny, competitors became more likely to merge).17 The effect of premerger notification on enforcement and deterrence is especially significant given the aggregate impact of exempt mergers on the economy. Later work finds that these mergers collectively affected $689 billion of output between 1994 and 2011.[18]

9 16 C.F.R. §§ 801.10(d), 801.2(f)(1)(i) (2022).

10 For ease of exposition, we assume that the target is smaller than the acquirer, which is almost always true in practice. This threshold applies if the target has $23.9 million in assets and the acquirer has $239 million in assets. Note that if the target is engaged in manufacturing, then the first criterion is satisfied if the target has at least $23.9 million in assets or $23.9 million in net sales. *See* 15 USC. § 18a (2018); Revised Jurisdictional Thresholds for Section 7A of the Clayton Act, 89 Fed. Reg. 7708 (Feb. 5, 2024).

11 Revised Jurisdictional Thresholds for Section 7A of the Clayton Act, 89 Fed. Reg. 7708 (Feb. 5, 2024).

12 16 C.F.R. § 801.1(a)(3) (2023).

13 Specifically, for a corporation, the UPE is the entity that holds 50 percent or more of the corporation's outstanding securities, or that has the current contractual power to designate 50 percent or more of the board of directors. For an NCE, the UPE is the one that has the right to 50 percent or more of the entity's profits or assets in the event of dissolution. 16 C.F.R. § 801.1(b)(1)(i) & (ii) (2023); 16 C.F.R. § 801.1(b)(2) (2023).

14 Wollmann, *Stealth Consolidation, supra* note 4, at 77.

15 Wollmann, *Stealth Consolidation, supra* note 4, at 78&81; Wollmann, *How to Get Away with Merger, supra* note 4, at 8.

16 Wollmann, *Stealth Consolidation, supra* note 4, at 78-85.

17 *Id*. at 87-89.

18 Thomas G. Wollmann, *Terms of the Deal Were Not Announced: Accounting for Mergers with Unpublicized Values*, 113 AEA Papers & Proc. 284, 287 (2023).

IV. PRIVATE EQUITY CHALLENGES

PE acquisitions can pose a threat to competition that goes beyond just stealth consolidation. These acquisitions might be particularly risky for competition due to certain aspects of US antitrust law, which can make many of these acquisitions hard to detect. Recall that the HSR Act's size-of-deal and size-of-transaction thresholds, as well as the treatment of non-corporate target acquisitions, fundamentally depend on the aggregation of control, which the Act defines using ownership interests. Our research shows that when this definition of control is applied to the investment structures commonly employed by PE funds, acquisitions that would ordinarily require notification instead are exempt.

PE acquisitions often require multiple entities to allocate fees, align incentives, and maintain confidentiality. Tax avoidance is the most common motivation. Tax-sensitive domestic investors may prefer to invest through a partnership to avoid double taxation. Conversely, domestic endowments, foundations, and pension funds may prefer to pass funds through a corporation, which shield them from business income that could create filing obligations and even jeopardize their tax-exempt status. Foreign investors have other concerns and requirements. Moreover, co-investment vehicles are often desired by large investors to reduce the fees they pay.

To illustrate, we construct a representative PE investment structure based on average contributions from different types of limited partners.[19] In this structure, the main fund holds a 16 percent stake in the portfolio company, while the two blockers own 45 percent and 11 percent, respectively. The co-investment vehicle holds 28 percent of the ownership interests. However, as all of these limited partners are passive, at least to a first-order approximation, the PE firm, acting through the fund's general partner, has complete managerial control over the underlying portfolio company.

This representative investment structure reflects how PE investments typically involve multiple co-managed entities. The application of the Act's definition of control to this structure yields two primary avenues through which PE deals can become exempt from reporting requirements.

First, when the ownership interests of a non-corporate portfolio company are spread among co-managed PE investment vehicles, no single entity is recognized as obtaining control over the company. To illustrate, consider the representative PE investment structure. General and limited partners hold shares and units in a main fund, two blocker corporations, and a co-investment vehicle. Collectively, they acquire 100 percent ownership of an operating company, which is structured as an LLC to avoid double taxation for a subset of the LPs. However, each entity acquires less than a majority of interests in the operating company. One of the blocker corporations acquires the highest share, at 45 percent.[20] Since the largest entity holds less than 50 percent of the ownership interests, the Act does not recognize a change in control of the portfolio company. As a result, regardless of the size of the transaction or assets of the acquirer, and despite the PE firm attaining complete managerial power over the operations of the portfolio company, this acquisition is not reportable.

Second, when the ownership interests of the portfolio company are divided among multiple co-managed investment vehicles, the Act views each entity in isolation. As a result, the jurisdictional tests that determine reportability are applied to each entity separately, and the presence of multiple entities creates the impression that each acquisition grants minimal control over the portfolio company. By failing to aggregate control in an economically meaningful way, the Act overlooks the fact that the aggregate value of interests over which the PE firm attains managerial power exceeds the jurisdictional thresholds.

To illustrate, consider a $200 million acquisition made under the representative investment structure. Furthermore, let's assume that the transaction was proposed in 2024, when the transaction value threshold was $119.5 million. Ordinarily, this merger would be reportable, as its value is above the threshold. However, if the deal was backed by a PE firm using the representative investment structure, the largest vehicle would obtain 45 percent of the $200 million transaction value.[21] As a result, the transaction value assigned to each investment vehicle falls below the threshold, making the acquisition exempt despite the fact that the entities are commonly managed.

The acquisition of a single portfolio company by co-managed entities is not inherently anticompetitive. However, such a threat could arise if the same investment structure subsequently acquires a direct competitor of the portfolio company in a concentrated market. The subse-

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19 We use data from Preqin, a leading source of data on PE fundraising, and Triago Capital, a placement agent and advisory firm that gathers data, to construct this structure. StepStone, *A Comprehensive Guide to Private Equity Investing* (2017), https://www.stepstonepw.com/wp-content/uploads/2020/10/201705-A-Comprehensive-Guide-to-Private-Equity-StepStone-Group.pdf; Antoine Drean, *Ten Predictions for Private Equity in 2017*, Forbes (Jan. 25, 2017), https://www.forbes.com/sites/antoinedrean/2017/01/25/ten-predictions-for-private-equity-in-2017/?sh=51a716a57db9.

20 We do not mean to imply that this is true in all cases. Some sponsors or their counsel may employ structures that aggregate most if not all LP stakes in a single holding company or a stack of holding companies. As a result, those structures will mitigate or eliminate the problem mentioned in this section.

21 See Wollmann, *Terms of the Deal Were Not Announced, supra* note 18.

quent acquisition would likewise go unreported for the same reasons that made the first acquisition exempt from notification. At the end, through two non-reportable acquisitions, the PE firm obtains the power to manage two competitors in a concentrated industry. The misalignment between the Act's definition of control and economic reality prevents the Act from reaching the PE firm that ultimately manages two or more portfolio companies through numerous investment vehicles, even when those portfolio companies are competitors in a concentrated industry.

In a 2023 study, we estimate the degree to which acquisitions backed by PE are exempt from notification using transaction-level merger data. To identify reported deals, we rely on information disclosed through the Early Termination Program, which encompasses the majority of transactions subject to reporting. Consistent with legislative criteria, we observe that premerger notification rates are exactly zero until transaction value reaches the threshold at which mergers must be reported to the agencies. Once transaction value crosses this threshold, notification rates increase sharply. Consistent with disparate treatment, PE-backed acquisitions are reported at notably lower rates—more than twenty-five percentage points lower for mergers valued between around $100 million and $500 million.[22]

The FTC's complaint does not mention whether transactions named in the suit against Welsh Carson and USAP were exempt from notification. As anesthesiology groups tend to be relatively small, acquisitions of these entities may not be reportable even when done by a single entity. However, the alleged structure that these firms employed aligns with our assertion that PE investors maintain interests in portfolio companies through various intermediary entities. For example, according to the FTC complaint, one of the Welsh Carson funds that held shares in USAP spread its ownership across four separate entities.[23]

V. CONCLUSION

PE-backed acquisitions are often exempt from premerger notification. Partly this occurs due to size-based tests that exempt small deals, which may nonetheless have profound economic effects. Partly this also occurs due to the idiosyncratic treatment of investment structures commonly employed by PE sponsors. In either case, anticompetitive transactions may go unnoticed for many years. This creates challenges for the agencies as well as the parties, who may face damages and the long, costly process of unwinding a series of transactions.

22 Asil, Barrios & Wollmann, *Misaligned Measures of Control, supra* note 6, at 81.

23 Complaint, *FTC v. US Anesthesia Partners, Inc.*, 13 (Sept. 21, 2023), https://www.ftc.gov/system/files/ftc_gov/pdf/2010031usapcomplaintpublic.pdf.

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