The Increasing Scrutiny of Healthcare Transactions

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››› KEY BOARD TAKEAWAYS

- Identify the ideal end game and several alternatives and work backwards to assess what actions need to be taken in the near- and long-term to succeed.
- Educate yourself on the current M&A and regulatory landscape. Since 2020, there have been many shifts in the market that change the types of available partnerships and transactions structures and how deals get done, including timelines, due diligence, regulatory review, and more.
- In this new regulatory environment where whole hospital acquisitions are being more carefully evaluated and private equity ownership is being highly scrutinized, transactions will require additional due diligence.
- Remember your duties to the organization's mission and the provision of high-quality care in the geographic area served by the hospital or system. Does the partnering organization allow your system to advance its mission and provide the best care to patients?
- Make a plan to communicate with your constituents, including physicians, employees, and the public, and follow through on that plan regularly.
- While every situation has its own unique considerations, surrounding yourself with counsel who has advised on these types of transactions will allow you to more carefully navigate each situation and ultimately increase the odds of a successful transaction.

The healthcare landscape has undergone a significant shift with more hospital transactions being announced and more private equity investment across the industry. A number of factors are fueling the rise of mergers and acquisitions (M&A) in the healthcare industry, particularly among hospitals and health systems, including rising costs (outpacing inflation), squeezing hospital margins, declining government funding (particularly as pandemic-related funding wraps up), nursing and physician shortages, and shifting payment models.

Overall, the M&A landscape in healthcare is complex, with a mix of financial pressures, strategic ambitions, and the need to adapt to a changing industry driving consolidation.

Hospital M&A

Hospital M&A activity increased in 2023, according to a report from Kaufman Hall. Nearly a third of the 65 announced transactions involved a financially distressed system—the highest proportion in recent history and up from 53 in 2022.[1] Predictions show that this trend is expected to continue in the coming year. While the number of deals is rising, the total revenue involved in these transactions is also significant, indicating larger and potentially more impactful mergers.

More distressed health systems seeking to consolidate follows a trend of hospitals posting consistently negative operating margins since 2022. As of November, median year-to-date operating margins sat at 2 percent, "well below the 3–4 percent range often cited as a sustainable operating margin for not-for-profit hospitals and health systems," according to Kaufman Hall.[2] For-profit and non-profit health systems also sought partnerships in "core" regional markets in 2023 to combine care networks and optimize the reach of scarce resources.

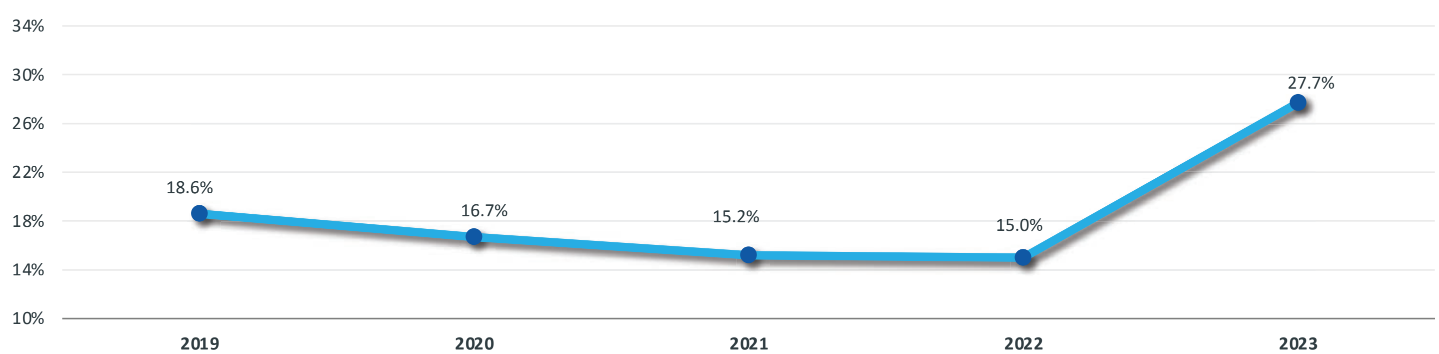
Private Equity Investment in Healthcare

For the past decade, private equity firms have invested more than $750 billion in a wide range of U.S. healthcare initiatives, including acquiring struggling hospitals, funding research and development in life sciences, and providing capital for physician practices.

Outcomes that come from private investments in healthcare services include improved efficiency, best practice sharing, access to capital, innovation, and positive patient outcomes. Private equity firms can provide much-needed capital for hospitals, which can be used to upgrade facilities, invest in new technologies, or expand services. This can be especially helpful for struggling hospitals that haven't fared as well due to market dynamics, increasing interest rates, and other economic factors.

Even so, private equity firms have drawn significant policy interest and scrutiny amid recent reports of surprise billing, rising out-of-pocket costs for patients, and increased healthcare spending in the U.S. Some of this has come to the forefront due to private equity-backed Steward Health Care garnering the news headlines over the last few months, given the 30-hospital system's filing for bankruptcy. Many news outlets have focused on this troubled story as an example of the negative impact of private

Percentage of Announced Transactions Involving a Financially Distressed Party



Source: Kaufman, Hall & Associates, LLC

1 Anu Singh, "Hospital and Health System M&A in Review: Financial Pressures Emerge as Key Driver in 2023," Kaufman Hall, January 18, 2024.
2 *Ibid.*

equity's role in healthcare. Steward, in its statement, indicated their financial distress resulted from the combined effects of low government reimbursement rates, increasing labor costs and inflation, as well as lingering impacts from the COVID-19 pandemic.[3]

Like any area, there are partners who are better options than others—there are good and bad actors across all industries. That is why it's always worth investigating potential partners and doing your due diligence. In looking at these shifts in market dynamics, hospital board members play a critical role in navigating these changes. This article explores the evolving regulatory landscape impacting hospital transactions and provides recommendations to help board members make informed decisions regarding their hospital's future.

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An Evolving Regulatory Landscape

While most analysts expect to see more whole hospital M&A and partnerships for ancillary services, some acknowledge that one aspect that could affect deal-making is the regulatory environment.

The Federal Trade Commission (FTC) has shown its willingness to oppose hospital mergers. The FTC has moved to block deals, particularly involving organizations in the same regions, saying they could lead to higher prices or reduced services for consumers.

There are two areas that hospital boards need to consider as they look at potential transactions and partnerships with third parties. The first is related to new merger guidelines released by the FTC and the U.S. Department of Justice (DOJ) Antitrust Division. The second is related to the rise in federal and state scrutiny of private equity investments in healthcare.

Merger Guidelines

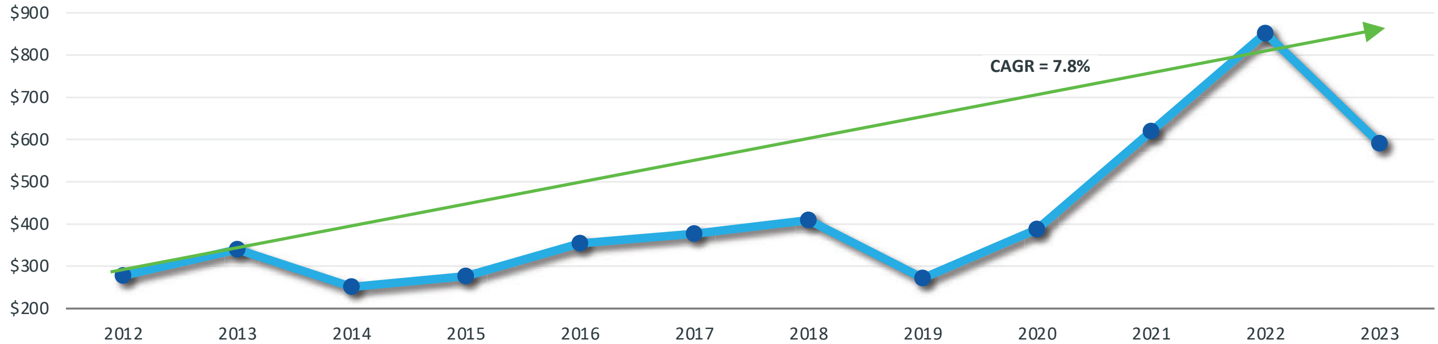
In December 2023, the FTC and DOJ Antitrust Division released their revised *Merger Guidelines*.[4] The guidelines significantly expand the number and types of transactions subject to antitrust challenge and apply stricter standards to proposed mergers between hospitals, insurers, and other healthcare providers. This reflects the FTC and DOJ's view that prevailing approaches to merger review have been too permissive and fail to identify and prevent transactions that harm consumers and workers, particularly in the healthcare industry.

The guidelines describe how the agencies evaluate whether transactions might violate Section 7 of the Clayton Act and "substantially…lessen competition, or tend to create a monopoly." The detailed explanations shed some light on the recent, more hostile, enforcement environment and will help companies understand in advance the nature of concerns that the DOJ and FTC might raise about contemplated transactions. Although the guidelines are not binding on courts considering merger challenges, past iterations have proven at least persuasive to many judges, and courts have incorporated standards and analyses from the guidelines into their decisions. The DOJ and FTC likely hope that by releasing "modernized" standards reflecting recent enforcement practices they might persuade more courts to consider and adopt aggressive interpretations of laws applicable to challenged transactions.

Several provisions in the guidelines are particularly relevant to mergers between hospitals, insurers, and other healthcare providers:

- **Presumption of harm**: The guidelines include presumptions that automatically render certain proposed mergers in the healthcare industry harmful to competition and make an extended review of these transactions a near certainty. For example, a presumption of harm arises when the combined firm resulting from a horizontal merger will have more than a 30 percent market share. The new presumptions are likely to have a chilling effect on potential acquisitions in the healthcare industry, as larger providers nearing the 30 percent threshold may be less likely to attempt to acquire even significantly smaller providers. Further, because there are usually a small number of hospitals in a given geographic market, the 30 percent market share threshold may serve as a difficult ceiling and prevent transactions in many areas, even when a transaction would benefit the community or fulfill a need.

Average Size of Smaller Party by Annual Revenue ($s in Millions)



Source: Kaufman, Hall & Associates, LLC

3 Alexander Gladstone, Laura Cooper, and Jonathan Weil, "Steward Health, Nation's Largest Physician-Owned Hospital Operator, Files for Bankruptcy," *The Wall Street Journal*, May 6, 2024.

4 "2023 Merger Guidelines," U.S. Department of Justice Antitrust Division.

- **Roll-up history**: To broaden the scope of transactions subject to review by the FTC and DOJ, the guidelines also focus on whether an acquiring company has employed a roll-up strategy of serial acquisitions—common in private equity. If there has been a roll-up history, the agencies may then consider the cumulative effect of the pattern or strategy on competition, rather than just focusing on the impact of the individual transaction on its own. The agencies have expressed concern that private equity firms, in particular, have avoided antitrust scrutiny through a series of smaller acquisitions, none of which individually would require a pre-merger notification filing under the Hart-Scott-Rodino (HSR) Act.
- **Smaller ownership stakes**: The guidelines also address transactions that involve less than full control of a target firm, so companies should not assume that they will avoid FTC and DOJ scrutiny by taking only a small ownership position in a target firm. The FTC and DOJ will assess whether a proposed transaction will result in either cross-ownership or common ownership that could be harmful to competition. An increased review of the potential effects of such transactions may impact the acquisition of non-controlling interests in joint venture limited liability companies (LLCs) or partnerships, which typically would not be reportable under the HSR Act.
- **Consideration of future market entrants**: The guidelines consider whether a proposed merger will eliminate a reasonably probable future market entrant, particularly in a concentrated market. This focus may present challenges for healthcare provider acquisitions, even by out-of-market providers. Previously, such transactions have not attracted significant antitrust scrutiny because the number of competitors in the market does not decrease. With this new consideration, agencies may advocate for potential market entrants to compete by building their own facilities from scratch, rather than by acquiring an existing facility in the market.

Investigating the Role of Private Equity

In addition to issuing updated *Merger Guidelines*, the FTC and DOJ are also collaborating with the Department of Health and Human Services (HHS) to investigate the role of private equity in the healthcare industry. In March 2024, representatives from the FTC, DOJ, and HHS participated in a public workshop examining private equity's role in the healthcare industry. A significant theme of the workshop focused on enforcers' belief that private equity investments have reduced the quality of care and worsened outcomes for patients and communities. Several speakers expressed concern about how private equity firms' financial motivations can undermine incentives to provide high-quality patient care, including how private equity firms often encumber healthcare providers with large amounts of debt and tend to have a short-term focus on financial performance.

To help identify potential enforcement opportunities, the FTC, DOJ, and HHS jointly launched a request for information (RFI) soliciting public comments on healthcare industry transactions—both reportable and not reportable under the HSR Act—involving insurers, private equity firms, and other alternative asset managers that may be negatively affecting patients, workers, and overall healthcare affordability. The FTC and DOJ also separately issued an RFI related to serial acquisitions across all industries, not only healthcare.

These actions show an increased government focus on competition issues in the healthcare industry specifically, and in private equity more generally.

Potential Consequences of Heightened Scrutiny

This increased focus on hospital transactions and private equity investment in healthcare systems obviously carries increased risk for parties interested in exploring future healthcare transactions. Government enforcers realize the power that comes with challenging proposed transactions. For example, in late 2023, John Muir Health and Tenet Healthcare chose to terminate the proposed acquisition by John Muir Health of Tenet's San Ramon Regional Medical Center in light of the FTC's lawsuit challenging that deal. The FTC touted this withdrawal as a major win for the agency. Parties may abandon other prospective deals if they fear there is a meaningful probability of a similar challenge.

However, there are plenty of benefits resulting from healthcare transactions, including those involving private equity investment. In light of the above statistics related to the high number of distressed health systems that have been involved with recent M&A activity, the infusion of resources can be particularly critical. In one recent example, the need to keep struggling facilities open was central to a court's decision denying the FTC's request for a preliminary injunction against Novant Health's bid to purchase two of Community Health Systems' hospitals in North Carolina. Deals that similarly work to keep facilities operational can succeed if they ensure continued community access to healthcare.

Looking Ahead

Potential deal participants can expect that the heightened scrutiny from government—whether FTC, DOJ, or other federal or state authorities—will only continue, and that these authorities will remain focused on competition in healthcare. States, in particular, are sometimes more nimble and adaptable with their enforcement strategies in response to changing industry conditions, including with proposed legislation addressing healthcare transactions and private equity ownership. We expect these authorities to proactively address healthcare transactions that they believe to be anticompetitive.

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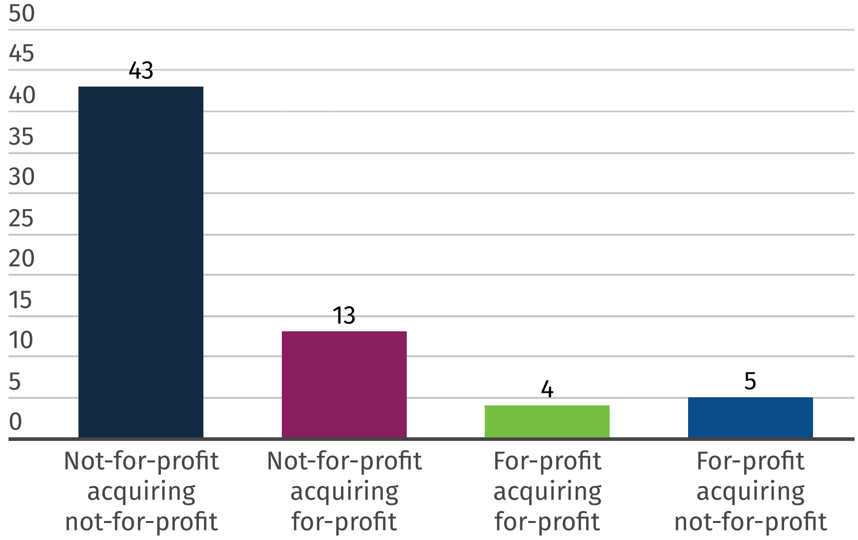
In response to this laser-like focus by government authorities, private equity firms should be prepared to adapt investment strategies accordingly and to develop procompetitive justifications for all their transactions. For example, firms may more often choose to invest in healthcare systems by holding non-controlling interests. Though the *Merger Guidelines* specifically address this strategy, it is undoubtedly more difficult for authorities to challenge non-controlling ownership of multiple entities than, for instance, direct control of one entity with a high market share. Even with a non-controlling interest, private equity firms can provide much-needed capital to help improve the quality of care provided to patients.

Ultimately, a central consideration of any private equity firm seeking to invest in a healthcare system should be the procompetitive benefits that are possible only through the proposed transaction. Private equity firms working to ensure high-quality, affordable healthcare through responsible M&A activities must be ready to demonstrate those benefits in any proposed deal, but understand that they may meet some initial skepticism from government authorities.

Implications for Hospital Boards

Mergers and acquisitions and outside investments in hospitals and health systems have increased significantly over the last several years. Each hospital and system has its own unique market, needs, and strategies. Regardless, the delivery of healthcare services has evolved over the last decade and will continue to do so and therefore, hospital board members have a bigger role than ever to play as their organizations address these challenges. With the increasing need for many hospitals to partner coupled with the heightened scrutiny from the FTC, DOJ, and state regulators, board members have a more complicated landscape to navigate than ever before. As boards consider partnerships for the entire hospital or system or for ancillary services, there are key considerations to make:

Not-for-Profit/For-Profit Deals in 2023



Source: Data from Kaufman, Hall & Associates, LLC

> *Boards need to carefully evaluate any potential partner as always, but in light of this new regulatory environment where whole hospital acquisitions are being more carefully evaluated and private equity ownership is being highly scrutinized, transactions will require additional due diligence.*

- **It's a marathon**: Think long-term in tandem with the short-term fixes that the hospital or system may need. Repeated short-term fixes may jeopardize long-term goals. Identify the ideal end game and several alternatives and work backwards to assess what actions need to be taken in the near- and long-term to succeed.
- **Increased due diligence**: Boards need to carefully evaluate any potential partner as always, but in light of this new regulatory environment where whole hospital acquisitions are being more carefully evaluated and private equity ownership is being highly scrutinized, transactions will require additional due diligence. For instance, a private equity-backed hospital system or ancillary service provider may be the perfect fit for your needs, but be aware of the added regulatory scrutiny and how that might impact the necessary due diligence and timeline to closing. Address regulatory compliance and minimize the impact on day-to-day operations to the greatest extent possible by the strategic decision making being undertaken.
- **Focus on mission**: Remember your duties to the mission of the hospital or system and the provision of high-quality care in the geographic area served by the hospital or system. Does the partnering organization allow your system to advance its mission and provide the best care to patients?
- **Transparency and communication**: Open communication with patients, staff, and the community is crucial regarding any potential transaction or partnership, particularly if private equity investment is involved. Make a plan to communicate with your constituents, including physicians, employees, and the public, and follow through on that plan regularly. Identify potential roadblocks and work proactively to address them. Being reactive lengthens the process and lessens the prospects for success.
- **Healthcare expertise and counsel**: Surround yourself with experts who have helped hospital management and boards with creative financial, operational, and legal decision making to preserve care, as well as those experienced in navigating the particular nuances that come with private equity investments to fully evaluate the various partner options and deal structures available. While every situation has its own unique considerations, surrounding yourself with counsel who has advised on these types of transactions will allow you to more carefully navigate each situation and ultimately increase the odds of a successful transaction.

While hospitals and smaller health systems undoubtedly face unprecedented challenges today, these times also present unique opportunities if tackled in a strategic and methodical way. The future of private equity involvement in healthcare remains uncertain. Hospital boards must be well-informed about the potential risks and take a proactive approach to ensure patient care and community well-being remain top priorities.

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