Articles + Publications | July 12, 2024

Money and Power at Odds: PE Meets Increased Oversight From State AGs

WRITTEN BY

Ashley L. Taylor, Jr. | Jeremy I. Levy | Michael Yaghi | Blake R. Christopher

BACKGROUND

The number of private equity (PE) funds and the amount of capital deployed through private equity investing have grown dramatically over the last several decades. Some PE firms are buyout firms — they purchase controlling equity positions in (usually privately held) operating companies — while other PE firms make minority investments, either alongside other PE firms or on their own. In both cases, PE firms are typically granted significant controls and protections by the companies in which they invest.

In recent years, PE has generated above-market returns. A 2021 analysis by McKinsey looked at a pool of PE funds and found that they produced a 13.3% median annual return through September 30, 2020.[1] That beat the annual average returns of the S&P 500 Index and the Russell 2000 Index during the same period.

Perhaps it should come as no surprise then that in 2019 an Ernst & Young report revealed that, commensurate with the increasing availability of private capital through PE and other sources, the number of publicly traded U.S. companies had declined by 50% since the 1990s.[2] Meanwhile, the number of PE funds in the U.S. soared from 1,000 to nearly 4,000.[3] As a result, during the period from 2012 to 2019, the number of PE-owned companies in the marketplace vastly outnumbered publicly traded companies, and the gap between the two seems likely to widen.[4]

Another trend likely to continue is the growing authority of state attorneys general (AGs). That topic has been the subject of myriad articles of late,[5] most of which agree that state AGs have never before sought to wield more regulatory authority than they do today.

PE MEETS STATE AGS IN HEALTH CARE

PE's expanding reach has gotten the attention of state AGs, and one key industry in which state AGs seem to be targeting PE firms is the health care industry. State AGs' oversight of PE involvement in health care is driven primarily by alleged quality of care and anti-trust concerns. Earlier this year, a bill was introduced in California that would grant the AG approval authority over PE firms' health care acquisitions.[6] The bill also imposed substantial restrictions on PE firms' ability to control acquired practices.[7] The California AG introduced that legislation, along with the assembly speaker pro tempore.

The bill set a "public interest" standard for determining whether the AG should approve or deny a PE firm's health care acquisition. It defined “public interest” as “being in the interests of the public in protecting competitive and accessible health care markets for prices, quality, choice, accessibility, and availability of all health care services for local communities, regions, or the state as a whole.”[8]

The legislation’s intent seemingly tracks a common argument by state AGs that while PE “may improve operational or technological efficiencies, there are concerns about the effects on cost, quality, and utilization of care.”[9] Some academics attribute these concerns to the fact that PE firms “typically mov[e] on from their health care investments within three to seven years …,” a common holding period for PE investments.[10]

On June 6, 11 state AGs submitted a comment letter in response to a request for information from several federal agencies. The letter focused on consolidation and vertical integration issues in the health care industry. The AGs highlighted PE involvement in nursing homes and hospitals as particular areas in need of greater antitrust scrutiny.

Specifically, the coalition argued that “private equity-backed physician practices now control access to over 50% of available health care services within … metropolitan areas.”[11] To counter this perceived problem, the coalition contends that “roll-up” health care transactions, which help consolidate multiple smaller entities into one larger organization, “should fall under the threshold for notifying federal antitrust authorities.”[12] The AGs went on to recommend additional enforcement and regulation, including a ban on anti-steering and anti-tiering provisions, and joint enforcement — across federal agencies and state AGs — to stop certain mergers and acquisitions.[13]

PE TO MEET STATE AGS IN REAL ESTATE AND TECHNOLOGY

The above recent developments in the health care industry could foreshadow hurdles for PE investments in real estate and technology industries. Data suggests that PE involvement in real estate has slowed.[14] Still, until lately, multifamily real estate was considered a “hot sector” for PE.[15] And, according to one study, “companies backed by private equity may own 40% of the nation’s single-family homes” by 2030.[16]

AGs’ authority over PE landlords varies by state. In some states, AGs provide broad information on landlord-tenant matters but cannot accept written complaints.[17] In other states, AGs receive rental complaints as part of their consumer protection offices — presumably, these AGs can investigate such complaints, or at least refer them for investigation.[18] And in the District of Columbia, the AG can ask a judge to appoint a receiver for a property when a landlord’s neglect endangers the health, safety, and security of the tenants; investigate improper withholding of security deposits, collection of illegal late fees or attorney’s fees, and harassing calls from debt collectors; and even sue landlords for alleged price fixing.[19]

While there is some evidence that PE investments in real estate may be cooling, PE investment in the technology sector is exploding. “[P]rivate equity led 57% of public-to-private technology deals in the first half of 2023 — almost double their share of public-to-private technology deals in 2020, 2021 and 2022.[20] Morgan Stanley called it “just [the] beginning.”[21]

Many commentators highlight the benefits of PE investment in the fast-moving technology industry. PE firms “have evolved into subject matter experts that offer technology companies operational expertise.”[22] Indeed, “[s]ome public tech companies are considering selling their companies to a financial sponsor to rebuild without the pressure of delivering returns in a difficult market environment.”[23]

Nonetheless, PE firms may expect an active state AG interest in PE's current and future technology investments. Technology companies span the full breadth of the American economy — from software and media to artificial intelligence and cybersecurity. All these sectors face mounting regulatory interest from state AGs, especially via their consumer protection offices.

LOOKING AHEAD

Perhaps there was a time when legal, political, and market limits on PE and state AG authority meant that the two were unlikely to interact. That time is no more. State AGs clearly have PE firms in their sights, and PE investment professionals would be wise to prepare for a future with greater regulatory oversight — perhaps not from Congress or federal agencies, but from state AGs.

Don't miss our previous articles on state AG offices in the PE space including:

California's AB 3129: Implications for Private Equity Investments in Physician Practices

AGs Focus on AI Has Implications for Private Equity Investors

Federal Court Dismisses Antitrust Claims Against Private Equity Firm

---

[1] Here.

[2] *Id.*

[3] *Id.*

[4] *Id.* The value of PE markets in the U.S. alone is expected to reach $460 billion in 2024. Here.

[5] *See*, *e.g.*, here.

[6] Here.

[7] *Id*.

[8] *Id.*

[9] Here.

[10] *Id.*

[11] Here.

[12] *Id.*

[13] *Id.*

[14] Here.

[15] *Id.*

[16] Here.

[17] Here.

[18] Here.

[19] Here

[20] Here

[21] *Id.*

[22] *Id.*

[23] *Id.*

RELATED INDUSTRIES + PRACTICES

- Private Equity
- Regulatory Investigations, Strategy + Enforcement
- State Attorneys General