ALERT MEMORANDUM

The Change Healthcare Decision and Implications for Private Equity Sponsors

October 11, 2022

Biden Administration Hostility to Private Equity Rejected by Federal Court

Biden-appointed antitrust officials have asserted, unfairly in our view, that private equity firms deserve heightened scrutiny when they engage in corporate transactions. For example, the head of the DOJ's Antitrust Division said in an interview with The Financial Times earlier this year that the private equity business model "is often very much at odds with the law and very much at odds with the competition we're trying to protect." The Chair of the Federal Trade Commission has similarly stated in a separate Financial Times interview that private equity firms' acquisitions can have "life and death consequences."

Agency criticism of private equity has just failed its first courtroom test. The U.S. Department of Justice and Attorneys General from Minnesota and New York filed a lawsuit challenging the $13 billion acquisition of Change Healthcare Inc. ("Change") by UnitedHealth Group Incorporated ("United"). District Court Judge Carl Nichols' opinion approved the acquisition of assets divested to address a competitive overlap by entities affiliated with TPG Capital ("TPG"). The Court held that "the evidence at trial established – and the Court finds – that TPG's incentives are geared toward preserving, and even improving, [the business's] competitive edge," rejecting DOJ's arguments to the contrary. Opinion at 24-25.

This is welcome news for private equity firms competing to be divestiture buyers. We do not, however, expect that the agencies will abandon their current aggressive enforcement policies, including those that disfavor private equity buyers. Given that the antitrust agencies (and particularly the DOJ) have adopted anti-settlement policies generally, merger parties proposing remedies to address competitive concerns raised by antitrust agencies will likely need to plan to litigate with the agencies. The United/Change case provides a path for merger parties and private equity divestiture buyers to prevail in litigation with antitrust agencies challenging the adequacy of divestitures to private equity.

Below is a brief description of the relevant holding in the United/Change case and what we see as implications going forward. Cleary Gottlieb represented Change Healthcare at trial in this case. The merger closed on October 3, 2022.

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The Divestiture

The competitive overlap that gave rise to the divestiture in this case was in an area known as "first-pass claims editing," a software product that health insurance companies use to analyze reimbursement claims. Both United and Change offered claims editing products for sale, sometimes in competition with each other, before the merger. The parties offered to divest Change's market-leading product, ClaimsXten. Opinion at 27. Following an auction process, the parties agreed to sell ClaimsXten and related assets to TPG for $2.2 billion.

The Court's Analysis of TPG and the Divestiture Remedy

Following an 11-day bench trial, the Court found that the proposed divestiture to TPG would adequately preserve competition in first-pass claims editing. The Court analyzed the divestiture using a five-part test proposed by the plaintiffs:

— Likelihood of the Divestiture: The Court found that the divestiture was a virtual certainty because all conditions under the acquisition agreement with TPG were satisfied, other than resolution of the government's lawsuit and conditions to be satisfied at closing. And in fact the divestiture transaction closed immediately after the merger.

— Experience of the Divestiture Buyer: The Court determined that TPG, together with the ClaimsXten management team that would continue with the business, had the experience necessary to ensure that ClaimsXten would remain competitive. Plaintiffs had argued that private equity buyers, as a class, lacked the same incentives to innovate as strategic buyers. Opinion at 24–25. The Court rejected this position, noting that private equity buyers earn a higher return on exit when the company under their ownership performs better. Specifically in the healthcare industry, the Court found that TPG has historically increased R&D spending of its healthcare companies by 156% and held its investments for an average of eight years. Opinion at 25. The Court also identified as favorable factors (i) TPG's position as one of the world's largest and most experienced private equity sponsors and ClaimsXten's management team's experience in the industry; (ii) TPG's plans to grow the business, including by doubling the R&D budget of the divestiture business over two years; and (iii) TPG's particular experience with carve-outs and in the healthcare industry.

— Scope of the Divestiture: The Court also found that the scope of the divestiture was sufficient to preserve competition. Plaintiffs had argued that TPG could not sell ClaimsXten in exactly the same way that Change had, alongside other payment accuracy products, a standard that would set a high bar for many carve-out divestitures. The Court found, however, that ClaimsXten had succeeded for many years before it was combined with other products cited by the plaintiffs, and that customers purchase it as a stand-alone solution. Opinion at 28. The Court also looked favorably on TPG's consideration of the scope of the carve-out transaction as having been a "core aspect of [TPG's] due diligence." Opinion at 26-29.

— Independence of the Divestiture Buyer from the Merging Seller: The Court found that TPG is independent of UnitedHealth Group, and its prior dealings with UnitedHealth Group at arm's length did not change this conclusion. Opinion at 30.

— Purchase Price: The Court had no difficulty finding the $2.2 billion price for ClaimsXten was adequate. Opinion at 31.

At trial, the plaintiffs suggested that TPG's debt financing plans raised concerns, but the Court did not find this to be significant.

Key Takeaways for Divestitures to Sponsors

— State of Enforcement: The antitrust agencies continue to have an anti-settlement policy and even after the United/Change decision, the agencies are likely to continue challenging the adequacy of divestiture remedies, including those involving private equity divestiture buyers. United/Change will be a helpful precedent that private equity

sponsors can effectively preserve competition following a divestiture.

— Certainty of Closing a Divestiture: A purchase agreement with minimal conditionality is most likely to pass judicial muster. Any financing-related or other non-standard conditionality might create risk that a court would find the divestiture insufficiently likely to close. Based on United/Change, typical debt financing, without creating significant additional closing conditionality, is not a problem in and of itself; however, we expect that the government will continue to focus on this in future litigation.

— Experience of the Divestiture Buyer and Management Team:

  - Private equity buyers should be prepared to demonstrate their experience and expertise in the relevant industry and should have a concrete plan for the target business. A court might view the plan particularly favorably if it shows growth in investment relative to the divestiture business's current situation.
  - While the Court in United/Change praised TPG's industry experience, given the Court's focus on management and employee retention, sponsors may want to insist that the merger parties transfer with the divested business a management team with the experience and expertise to ensure the continued competitiveness of the divested business. Private equity buyers should consider proposing an incentive or retention plan even prior to closing of the divestiture.

— Scope of the Divestiture: Sponsors should thoroughly diligence the scope of the carve-out to ensure that the divestiture adequately addresses the competitive overlap in the merger and that the target business can operate on a standalone basis. It is in everyone's interest to ensure the correct transaction perimeter.

— Independence of the Divestiture Buyer from the Merging Seller: A potential buyer with no or a minimal existing relationship with the merging seller, and minimal need for a continued relationship between the merging seller and the divested business, may have the greatest advantage.

— Purchase Price: Although divestiture buyers may have more pricing leverage than in a standard process, the legal framework does require an analysis of the sufficiency of the purchase price for the assets, which agencies often use as a proxy for how committed divestiture buyers are to the future success of the divested business. If it is a strong business, the auction process is likely to result in an adequate price in any event.

— Litigation Process: Buying a divestiture business where the government might challenge the underlying transaction in court requires significant litigation planning and effort by the divestiture buyer. Buyers should expect to receive burdensome discovery requests and key personnel involved in the transaction may be deposed. It will be essential to have someone on the team who can testify and explain to a court what the buyer did to verify the scope of the assets and what its plans are for the business going forward. Qualified antitrust and litigation counsel should be consulted early in the process.

— For further information about "litigating the fix," *see* Gelfand and Brannon, *A Primer on Litigating the Fix*, Antitrust Magazine Vol. 31 at 10 (Fall 2016).

— More information about the Cleary Gottlieb antitrust group can be found here. Questions regarding the United/Change case can be directed to David Gelfand and Dan Culley of Cleary Gottlieb, who represented Change Healthcare at trial.

— For more information about Cleary Gottlieb's U.S. private equity M&A practice, please contact David Leinwand, Matt Salerno, John Kupiec or Paul Imperatore.

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