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Storm Clouds on the Horizon:

Private Equity and the False Claims Act

The United States recently filed a False Claims Act Complaint in Intervention against Florida-based compounding pharmacy Patient Care America ("PCA"), two PCA employees, as well as the private equity ("PE") firm that acquired PCA and helped manage the company.[1] The scheme alleged by the government was a common one: the payment of kickbacks for referrals of expensive compound drugs, which were often paid for by Tricare, a federal healthcare program. What was uncommon was the federal government's intervention against a PE firm. The government's efforts have paid off. On September 18, 2019, the government announced that it had settled the case, with the pharmacy and its private equity owner agreeing to pay over $21 million to the government.[2]

Similarly, in *Commonwealth ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*,[3] the relator filed suit against a mental health services provider and its PE firm owner. While the United States declined to intervene, the Commonwealth of Massachusetts intervened in the case and has sought to hold the PE firm liable.[4]

The *Patient Care America* and *Martino-Fleming* cases may reflect a renewed focus on PE firms in the False Claims Act ("FCA") arena. While it remains to be seen whether the cases are omens, outliers, or indicative of a potentially more longstanding, but unstated, governmental focus on private equity,[5] PE firms should proceed with caution when investing in and managing healthcare companies and other entities subject to FCA enforcement. Meanwhile, their counsel should endeavor to understand the unique financial and managerial dynamics that may place PE firms in the government's crosshairs. Unlike, say, mutual fund investments, which a typical defense attorney is likely to fully grasp, private equity remains a niche investment area largely limited to institutional investors and high net worth individuals. Private equity operates in a fundamentally different manner than mutual funds and similar investments. Defense counsel must fully appreciate the unique dynamics that define private equity investments in order to represent their clients in FCA investigations and lawsuits. To that end, counsel should understand the financial structures of such investments, the due diligence process leading up to PE transactions, and the oversight role played by PE firms in managing their investments.

I. Private Equity Deals: A Primer

Private equity transactions nearly always operate under a "buy to sell" model. The PE firm (or a consortium of firms investing together) effectuates a leveraged buyout ("LBO") of the target company, using substantial amounts of debt (the titular leverage) to finance the acquisition. Oftentimes the debt to equity ratio is in the range of 2:1 to 3:1. The cash flow from the acquired company is used to service the multimillion dollar debt from the LBO, which takes years to pay off. The debt is substantial as to size and interest rates, which, for subordinated debt, can eclipse 15 percent per year.

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PE firms believe that by acquiring the company and taking over its management they can drive growth and profitability, allowing them to sell a larger, more profitable company at a later date (typically around four to six years after the LBO) at a substantial profit. The problem with the managerial facet of the PE model is that the more the PE firm takes over operations, the more likely it is that the government (or a relator) may accuse the firm of knowingly playing a role in fraudulent conduct occurring at its portfolio company, raising the specter of FCA liability.

The risk is particularly acute in highly regulated industries like healthcare. Healthcare is not just a perennial focus of FCA enforcement but has, particularly in recent years, become a major area of PE investment, creating a regulatory perfect storm for PE firms. Healthcare companies often operate in fragmented, high-growth markets and have robust profit margins, making them (at least absent compliance problems) ideal targets for an LBO. Yet PE dealmaking as a whole remains down, with such transactions declining nearly 20 percent since 2014, the private equity peak during the current bull market. That likely reflects that PE firms, flush with cash from still relatively low interest rates, are engaged in stiffer competition for target companies. Rather than risk overpaying for a safer company, some PE firms may be tempted to purchase companies that appear to be relative bargains but which may be lemons due to compliance shortcomings. While investing in a company that becomes the target of government enforcement may itself prove financially devastating (the road to healthcare riches is littered with companies pushed into bankruptcy due to compliance issues), when the PE firm itself becomes the target of government scrutiny (and particularly government intervention), the financial and reputational risk is far more acute.

II. Due Diligence

Before any acquisition, a PE firm engages in extensive due diligence into both the financial and regulatory facets of the target company.[6] Given the massive amount of debt that the PE firm will be obtaining, there is little room for error in this regard. A single misstep in analyzing the target company's legal compliance could spell disaster if, following the acquisition, the company faces an enforcement action. This is, in some respects, helpful in terms of contesting FCA liability, given the FCA's requirement that wrongdoing be knowing. A PE firm may be able to argue that, had it known that the portfolio company was engaged in fraud, it never would have invested in the company. Yet that may be no silver bullet. A PE firm may be seen as turning a blind eye toward compliance concerns in the pursuit of profits (particularly in cases where the target company sports remarkable growth and profits).

Government attorneys and investigators will likely seek all analyses performed and communications made during due diligence, at least when the allegedly fraudulent conduct began before the buyout. Once retained, counsel for the PE firm should do the same. Much of the information a PE firm collects via due diligence is retained in a virtual "data room," a digital repository of documents provided during due diligence, making it easy for defense attorneys (as well as the government) to collect. The data room will also tend to be organized by subject matter (e.g., compliance, financial statements, and marketing documents will be grouped together), greatly facilitating document searches and review. Thus, not only will the data room provide an extensive cache of documents concerning the origin of the PE firm's relationship with the portfolio company, but this may also very well be the easiest evidence in the case to collect and review.

The review of due diligence evidence should not necessarily be limited to the client PE firm's own due diligence efforts. When multiple PE firms consider an acquisition as part of a consortium (a "club deal," in industry lingo), the partner PE firms will often perform their own due diligence and share their analysis, questions, and concerns about the target company. Debt lenders, who put up most of the funds for any LBO, tend to perform fairly extensive due diligence as well that may be shared with their PE firm partners. If another PE firm or a lender has performed due diligence that puts the target company's compliance in question, that will likely be the subject of government scrutiny. Even worse, if a potential partner lender or partner PE firm backs out of a transaction due to compliance concerns, that may reflect poorly on the PE firm that ultimately purchases the target company.

Accordingly, the due diligence process may cut both ways. If the due diligence was vigorous and unearthed no compliance concerns, the PE firm may be able to argue that it relied on its experts and had no knowledge of wrongdoing when it purchased the company. Even then, defense counsel must carefully consider that relying on a due diligence report may amount to an advice of counsel defense, which will waive the attorney-client privilege over the operative subject matter, including any attorney-client communications suggesting that the scrutinized practice was illegal.[7] In some cases, the waiver may be so broad as to waive privilege over relevant advice offered to the PE firm up to and including trial.[8] In crafting a defense that relies on legal advice offered during due diligence (or at any other juncture), defense counsel should make certain to review all legal advice offered to the PE firm.

If due diligence has raised substantial concerns over compliance — particularly if those concerns go unaddressed following an acquisition — then the due diligence process may become a focal point of the government's case. Even beyond the question of conventional "direct" liability under the FCA, a PE firm that knowingly acquires, in whole or in part, a company engaged in fraud may face claims of conspiratorial liability — the theory being that the PE firm has paid the target company's owners for an opportunity to partake in the management and fruits of the fraudulent enterprise. Conspiratorial liability is particularly concerning given the wide net it casts as to both liability and damages. Pertinent considerations include the following:

> (1) a tacit agreement, even shown entirely through circumstantial evidence, can establish conspiratorial liability;[9]
>
> (2) a conspirator need not engage in an "over act" to be held liable, only a single member of the conspiracy needs to do so;[10]
>
> (3) the intracorporate conspiracy doctrine's application is unsettled in the context of the FCA generally and the PE firm/portfolio company relationship specifically;[11]
>
> (4) a party that enters into a conspiracy may be liable not just for conduct going forward but also for conduct occurring before his or her entrance into the conspiracy;[12] and
>
> (5) conspiratorial liability under the FCA is joint and several.[13]

The financial dynamics of a PE deal may also go under the microscope as sunk cost dynamics come into play. Due diligence is typically a lengthy, multimillion dollar endeavor and many of the PE firm's employees working on the proposed transaction will be focused on the transaction at the expense of other potential or actual investments. The enemy of a PE firm is client money sitting idle (so-called "dry powder"), and this is doubly true when interest rates rise and the window for economically ideal private equity transactions begins to close. In some transactions, a termination fee may be triggered if the PE firm backs out of the deal. Particularly if compliance issues arise late in the due diligence process, then the government may claim that the PE firm was "in too deep," such that it was unwilling to back out despite compliance qualms. Defense counsel must be able to explain why, at all times, the client was engaged in a good faith assessment of the acquired company, instead of one swayed by the attractive financial figures that so often go hand in hand with fraudulent business practices.

Relying on a due diligence report may amount to an advice of counsel defense, which will waive the attorney-client privilege over the operative subject matter.

Defense counsel should therefore focus on four issues:

1. what due diligence was performed by the PE firm;
2. what due diligence was performed by lenders and any proposed or actual partner PE firms;
3. whether the PE firm, after the acquisition, received any additional compliance analyses (from counsel or other sources); and
4. the financial implications for the PE firm if the deal was terminated due to compliance concerns.

III. A Fish Rots from the Head Down: Management and FCA Liability

Private equity's edge compared to mutual funds and other passive investments (in addition, of course, to high leverage) is managerial knowhow. That same edge becomes an Achilles' heel in the context of the FCA. As previously noted, PE firms operate under a "buy to sell" model. The government and relators are likely to argue that PE firms are not passive investors and have knowingly taken a role in facilitating fraudulent conduct. Notably, in the *Martino-Fleming* matter, in adjudicating the PE firm's motion to dismiss the relator's complaint, the district court recognized that:

> Because it is alleged that H.I.G. [the private equity firm] members and principals formed a majority of the [portfolio companies] C.I.S. and South Bay Boards, and were directly involved in the operations of South Bay, the motion to dismiss the H.I.G. entities is also denied. A parent may be liable for the submission of false claims by a subsidiary where the parent had direct involvement in the claims process.[14]

The district court's logic in the *Martino-Fleming* decision is generally consistent with another district court case (albeit not one involving a PE firm), *United States ex rel. Schagrin v. LDR Industries, LLC*,[15] where the district court held that individuals who own and manage a company knowing it to be engaged in fraud "can be liable under the False Claims Act for failing to rectify the situation."[16] Ultimately, *Martino-Fleming*, *Schagrin*, and the wide breadth of FCA liability generally, may put PE firms at risk.[17]

The recent scrutiny on private equity is understandable. PE firms tend to be highly active managers of their portfolio companies and, given the "buy to sell" approach, are typically focused on effectuating high growth in the acquired company. PE firms do not just pore over balance sheets but often get involved in various managerial tasks in the quest for growth and profits.[18] By providing managerial knowhow, the PE firm can take the reins and build a more profitable company that can then be sold at a handsome profit. This managerial role is one of the key characteristics differentiating PE investments from more conventional passive investments.

Either individually or with partner PE firms, a PE firm will tend to own a majority of the portfolio company's equity. Few PE firms will take the risk of a sizable investment in an illiquid asset unless they hold a controlling portion (either alone or with partner PE firms) of the portfolio company's voting shares. Given the sums of money at issue, small margin for error (given the need to service the heavy LBO debt), and the need to drive growth and profitability for a future sale, PE firms tend to have multiple seats on the acquired company's board, have full power (given their equity stake) to hire and fire executives, and may also take part in management decisions outside the scope of the board.

Yet whether the PE firm's management of its portfolio company is sufficient to create FCA liability is a fact-intensive matter. The question may largely boil down to whether the PE firm was hands-on enough to be aware of any compliance failures and, if it was so aware, what steps it took to remediate any compliance problems. The inquiry will depend not just on the general nature of the PE firm's managerial activity (which may range from nearly day-to-day management to only high-level oversight) but also on the extent of the problematic activity. If the fraud afflicts a substantial part of the company's business model, then it will be more difficult for the PE firm to argue that it was unaware of the conduct. For example, in the *Patient Care America* case the alleged kickback appeared to be a major facet of the portfolio company's business model, one that arguably could not have fallen through the cracks of private equity oversight given its size and nature. Unlike more nuanced regulatory mandates, the Anti-Kickback Statute, at issue in *Patient Care America*, is likely to be well within the ken of most healthcare investors. Whether the government would have sought to hold the PE firm liable had the alleged fraud been subtler is unclear. Meanwhile, if the scrutinized conduct is limited in time and scope, then a PE firm may be able to prove it was unaware of the allegedly improper activity. PE firms are, after all, not omniscient. Yet this is a troubling dynamic. It is likely to be the case that the greater (and, thus, more obvious) the fraud, the greater the risk that the government will seek to hold the PE firm liable.

Individual PE firms also frequently focus on certain industries. If a PE firm is familiar with a specific industry, it will make it more difficult for the firm to claim that it was ignorant of the regulatory mandates governing that industry, either in relation to its pre-LBO due diligence or its subsequent oversight of the company. In fact, in the government's Complaint in Intervention in *Patient Care America*, prosecutors noted that the private equity firm was a serial investor in the healthcare space.[19]

Accordingly, defense counsel should fully investigate the role of the PE firm as an owner and a manager of the portfolio company, focusing on the following:

1. the percentage of shares owned by the firm and any partner PE firms;

2. the PE firm's role on the portfolio company's board and any other managerial roles it may have (e.g., whether the PE firm has members on the compliance committee);

3. the PE firm's experience, if any, in the specific industry;

4. the PE firm's knowledge of the legal requirement(s) that the portfolio company has potentially violated;

5. the extent of any compliance failures;

6. the PE firm's knowledge of any compliance concerns; and

7. the PE firm's efforts (if any) to reign in the scrutinized conduct and effectuate compliance.

IV. Financial Undercurrents

Given that the lifeblood of private equity is the LBO, the financial structure at play makes a PE firm an attractive target for FCA enforcement. PE firms may siphon off much of the portfolio company's profits in the form of distributions (e.g., dividends) and fees. As the *Patient Care America* case shows, at least in some cases, the government may think twice about allowing PE firms to profit off the alleged fraud without facing liability. Defense counsel should also keep in mind that, because of the substantial debt service from an LBO, much of the cash flow from an acquired company will be used to service debt. In addition, PE firms typically do not want a cash-rich portfolio company and thus will push the company to spend any excess cash, typically on growth initiatives (e.g., acquisitions) or by paying down debt early.

This all creates a dynamic in which the portfolio company may be unable to fund an agreeable settlement with the government, as the allegedly ill-gotten gains have already been sent to investors (or reinvested into the portfolio company). Even companies sporting $100-million-plus valuations may have only a few million dollars in cash on hand.[20] This financial reality may force the government's hand in pursuing a PE firm in that the lowest hanging fruit may not have the funds to finance an adequate settlement. Relatedly, and perhaps more obviously, PE firms tend to have deep pockets and access to additional capital, making them particularly appealing targets when damages are substantial and the entity in which they have invested is strapped for cash.

Even if due diligence fails to unearth any problems, a PE firm that unwittingly invests in a company that it later learns is noncompliant may find itself between a rock and a hard place. On the one hand, the PE firm can allow the problematic conduct to continue and potentially face the full wrath of regulators if the government takes notice, a particularly risky gambit. On the other hand, the PE firm can use its power to ensure compliance. This is the safer approach but one that is not without financial consequences.[21] In cases where the portfolio company is financially dependent upon the alleged fraud, a shift away from such practices could put the company's ability to service its debt at risk, leading to insolvency or the need to expend substantial sums of money to pivot toward other high profit, yet compliant, business opportunities.

Defense counsel should understand these financial dynamics not just in the context of internal investigations and contesting liability, but also in approaching any settlement with the government. In cases where settlement is prudent but the portfolio company is too financially stretched to finance an acceptable settlement, the PE firm may consider providing the portfolio company with funds to effectuate the settlement. If the government can be provided a fair recovery via the portfolio company (even if financed, in part, by the PE firm), that may head off an enforcement action against the PE firm itself, saving it from additional liability and the untoward reputational harm that would flow from a direct action against the PE firm.

The reputational harm from an FCA lawsuit can hardly be gainsaid. PE firms, which make big, long-term, and relatively undiversified bets using client money, live and die on their reputation and ability to show investors that they are investing in, and managing, companies in a prudent manner. A PE firm subject to an enforcement action may be put in a particularly unenviable position if it has failed to enforce compliance at its portfolio company. In defending itself, the PE firm could be forced to argue that it was unaware of the alleged fraud. While that may be singularly helpful in contesting the government's case, it may reflect poorly on the PE firm's due diligence and managerial ability, skills which are paramount in the eyes of a PE firm's clientele.[22] Defense counsel should approach cases in a manner which can, to the extent possible, minimize reputational harm.

V. Conclusion

Ultimately, as private equity firms continue to invest in industries that have high FCA exposure like healthcare, it may be that cases like *Patient Care America* and *Martino-Fleming* become more common. Defense counsel should become attuned to the complex workings of private equity, both before and after the operative transaction, and how those dynamics may lead to government scrutiny.

Notes

1. *United States ex rel. Medrano, et al. v. Diabetic Care RX, LLC, et al.*, 15-cv-62617, Dkt. 36 (S.D. Fla.) [hereinafter *Patient Care America*].

2. *Compounding Pharmacy, Two of Its Executives, and Private Equity Firm Agree to Pay $21.36 Million to Resolve False Claims Act Allegations*, U.S. Dept. of Justice, Sep. 18, 2019, https://www.justice.gov/opa/pr/compounding-pharmacy-two-its-executives-and-private-equity-firm-agree-pay-2136-million.

3. *Commonwealth ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*, 15-13065-PBS (D. Mass.).

4. *Martino-Fleming*, 15-cv-13065, Dkt. 84 (D. Mass.).

5. While historically the government has rarely intervened against private equity firms, lack of intervention does not equate to lack of scrutiny. In many cases involving PE-backed companies, the government may still investigate the PE firm and the PE firm may help to fund any settlement. Thus, even if in those cases, if formal intervention against the PE firm is avoided, the PE firm is still forced to face a not insubstantial regulatory burden.

6. Evidence from the due diligence process will, of course, be less pertinent if the portfolio company began its allegedly fraudulent conduct following the buyout.

7. *E.g., United States ex rel. Lutz v. Berkeley Heartlab, Inc.*, 9:11-CV-1593-RMG, 2017 WL 1282012, at *3 (D.S.C. Apr. 5, 2017) ("When a party asserts an advice of counsel defense, he waives the attorney-client privilege as to the entire subject matter of that defense."); *United States ex rel. Cairns v. D.S. Med., L.L.C.*, 1:12CV00004 AGF, 2017 WL 3887850, at *3 (E.D. Mo. Aug. 31, 2017) ("When a party raises an advice of counsel defense, all advice on the pertinent topic becomes fair game.") (internal quotation marks omitted).

8. *E.g., Lutz*, 2017 WL 1282012, at *3 ("Courts in this circuit [the Fourth Circuit], have found that when a party asserts an advice of counsel defense that the privilege waiver applies to advice received during the entire period the misconduct is alleged to have been ongoing — even up to and during trial").

9. *United States ex rel. Millin v. Krause*, 1:17-CV-01019-CBK, 2018 WL 1885672, at *12 (D.S.D. Apr. 19, 2018) ("A plaintiff need not provide proof of express agreement, but must establish a tacit understanding between the parties which may be shown wholly through the circumstantial evidence of each defendant's actions.") (internal quotation marks omitted).

10. *See, e.g., United States ex rel. Amin v. George Washington U.*, 26 F. Supp. 2d 162, 165 (D.D.C. 1998) ("The court is mindful that an overt act need not be pleaded against each defendant in a conspiracy, because a single overt act by one of the conspirators can support a conspiracy claim, even on the merits.").

11. The court in *Martino-Fleming* found the intercorporate conspiracy doctrine applied, at least on the pleadings, to a PE firm's relationship with its portfolio company, but explicitly noted that the complaint could be amended should discovery reveal that the PE firm and its portfolio company were "independent centers of decision-making." *Martino-Fleming v. S. Bay Mental Health Ctr., Inc.*, 334 F. Supp. 3d 394, 403 (D. Mass. 2018). It should be kept in mind that whether the intracorporate conspiracy doctrine applies at all in FCA cases remains an open question. *E.g., Krause*, 2018 WL 1885672, at *12 (describing split in authority over whether the intracorporate conspiracy doctrine applies in the context of the FCA). Further, where the alleged conspiracy precedes the buyout, application of the doctrine may be more difficult to establish because the parties would then be corporate strangers.

12. *See, e.g., In re Lower Lake Erie Iron Ore Antitrust Litig.*, 710 F. Supp. 152, 154 (E.D. Pa. 1989) (finding, in antitrust case, the "prevailing" view that the "late joinder" rule applies equally to civil as well as criminal conspiracies); *In re Am. Principals Holdings, Inc. Securities Litig., M.D.L. 653*, 1987 WL 39746, at *19 n.10 (S.D. Cal. July 9, 1987) (applying the late joinder rule in a securities case).

13. *See, e.g., United States v. Bd. of Educ. of City of Union City*, 697 F. Supp. 167, 177 (D.N.J. 1988) (holding that FCA conspirators were jointly and severally liable).

14. *Commonwealth ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*, CV 15-13065-PBS, 2018 WL 4539684, at *5 (D. Mass. Sept. 21, 2018).

15. *United States ex rel. Schagrin v. LDR Industries, LLC*, 14-cv-09125 (N.D. Ill.).

16. *United States ex rel. Schagrin v. LDR Industries, LLC*, 14-cv-09125, 2018 WL 6064699, at *6 (N.D. Ill. Nov. 20, 2018); *see also United States v. Pres. and Fellows of Harvard College*, 323 F. Supp. 2d 151, 187 (D. Mass. 2004) (finding that a defendant "operat[ing] under a policy that causes others to present false claims to the government" may be liable under the FCA and further explaining that "[w]here the defendant has an ongoing business relationship with a repeated false claimant, and the defendant knows of the false claims, yet does not cease doing business with the claimant or disclose the false claims to the United States, the defendant's ostrich-like behavior itself becomes a course of conduct that allowed fraudulent claims to be presented to the federal government.") (internal quotation marks omitted).

17. While the Intervenor Complaint in *Patient Care America* was subject to a Motion to Dismiss, resulting in a partial dismissal without prejudice (the Complaint was later amended), the district court's adjudication of the Motion did not address the PE firm's liability vis-à-vis its role in the portfolio company. *United States ex rel. Medrano v. Diabetic Care RX, LLC*, 15-CV-62617, 2019 WL 1054125 (S.D. Fla. Mar. 6, 2019). While the government's Amended Complaint was subject to a second round of dismissal motions, on July 1, 2019, the case was stayed pending an imminent settlement. *Patient Care America*, 15-62617, Dkt. 178 (S.D. Fla.) Accordingly, *Patient Care America* is unlikely to yield any helpful case law concerning PE firm liability.

18. In some cases, a PE firm may, in addition to any distributions from the portfolio company, obtain a management fee for its role in the portfolio company's oversight, which may suggest to the government how involved the PE firm is in managing its portfolio company.

19. *Diabetic Care RX, LLC*, Dkt. 36, Compl. ¶ 39.

20. Ideally, the portfolio company has obtained insurance policies covering FCA liability. However, the presence of such an insurance policy is no sure thing and, even when available, the policy may not sufficiently cover the full extent of FCA liability.

21. Depending on the facts, it may be in the PE firm's best interest to self-report the compliance failures to avoid the full brunt of the FCA. This can limit liability and put a bookend on regulatory overhang. Such finality may be important to the PE firm, as it will likely find its shares in the portfolio firm unmarketable while the company remains under investigation (assuming liability is substantial), a tough reality in the "buy to sell" world of private equity. However, self-reporting may create instant financial liability that may be particularly difficult to finance given the debt burden from the LBO.

22. These concerns may be lessened in cases where the sellers of the portfolio company affirmatively misled their PE suitors as to the relevant compliance shortcomings. In those cases, a PE firm may be able to claim, in a more palatable manner, that it was merely the victim of investment fraud. ■

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