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Private Equity Firm Faces FCA Liability for Portfolio Company's Alleged Misconduct

DOJ's intervention against PE firm defendant may signal increased exposure for PE firms under the False Claims Act.

Earlier this year, the US Department of Justice (DOJ) sued a private equity (PE) firm in a False Claims Act (FCA) lawsuit involving a military healthcare contract held by one of the firm's portfolio companies. That case, *United States ex rel. Medrano v. Diabetic Care Rx, LLC*,[1] may suggest increased FCA enforcement efforts against PE firms. In a press release touting its intervention decision, DOJ explained: "We will hold pharmacies, *and those companies that manage them*, responsible for using kickbacks to line their pockets at the expense of taxpayers and federal health care beneficiaries."[2]

This *Client Alert* provides a practical overview of: (1) FCA law and precedent that extends potential liability to third parties, including PE firms; (2) the facts in the *Medrano* case that led to DOJ suing the PE firm for the alleged misconduct of its portfolio company; (3) examples of potential areas of FCA exposure for PE firms; and (4) steps that a PE firm can take to help reduce this FCA exposure.

FCA Third-Party Exposure

The FCA is the US government's primary tool to address fraud related to the performance of government contracts.[3] Congress expanded the FCA statute in 2009 and 2010. The number of FCA-based fraud claims against government contractors has grown in recent years, resulting in a steady drumbeat of larger and larger settlements (which sometimes are for hundreds of millions of dollars). In 2017, the government recovered US$3.7 billion in settlements and judgments from defendants under the civil FCA.[4]

The statute provides the government with broad investigatory powers and deputizes private individuals and entities to act as whistleblowers who pursue claims on behalf of the government (and collect a share of the recovery).[5] The FCA imposes steep financial consequences for companies and individuals found liable for violations: treble damages and civil penalties between US$11,181 and US$22,363 per false claim.[6] In addition, FCA violations can lead to criminal prosecution and/or suspension and debarment proceedings, which can result in precluding a company from receiving government contracts for three years.

While FCA defendants are usually government contractors and/or healthcare companies, the potential for FCA liability extends to third parties, including PE firms. Even if a company does not do business directly with the government, it may still have FCA exposure if, for example, it causes the prime contractor to submit a false claim. The FCA imposes potential liability for any party that "knowingly makes, uses, *or causes to be made or used*, a false record or statement material to a false or fraudulent claim."[7]

DOJ's Theory of PE Firm Liability in *Medrano*

While whistleblowers occasionally name PE firms as defendants,[8] the *Medrano* case is one of the only times DOJ has filed an FCA complaint against a PE firm. According to the complaint, the portfolio company, Diabetic Care Rx, LLC, d/b/a Patient Care America (PCA), knowingly submitted false or fraudulent claims for reimbursement under TRICARE, a massive military healthcare program. PCA allegedly changed course in early 2014 and entered the compound pain cream business in light of the high TRICARE reimbursement rates for pain cream products. According to DOJ, PCA engaged in a marketing scheme involving a compound topical pain cream in which PCA paid kickbacks to marketers for referring patients to its pharmacies, paid patients by covering co-payments to encourage them to buy compounded drugs from PCA, and honored drug prescriptions by healthcare providers lacking a valid patient-provider relationship with patients.[9]

Riordan, Lewis & Haden, Inc.'s (RLH) PE fund held a controlling interest in PCA, which it had acquired in 2012 through an investment in Diabetic Care Rx LLC (DCRX), as PCA was known at the time. RLH allegedly "managed and controlled" PCA through two RLH partners who served as officers of DCRX and also as officers and board members of DCRX Acquisition Corporation, the entity that managed DCRX.[10]

DOJ's complaint asserts that RLH was responsible for DCRX's entry into market for the topical compounding drugs at the heart of PCA's illegal kickback scheme.[11] RLH also had a hand in selecting DCRX's CEO, Patrick Smith, who is named as an individual defendant in the action.[12] One of RLH's lead partners recommended the selection of DCRX's CEO even though RLH had been told that his selection would "require more careful management than [RLH] may wish to provide."[13] After his hiring, RLH allegedly "directed and oversaw" the CEO, who agreed to "apprise[] [RLH] as early as possible about significant developments or concerns" and involve RLH in "important decisions starting at an early stage in the consideration process."[14] DOJ alleges in numerous parts of its complaint that RLH was aware of the circumstances surrounding DCRX's improper activities.

Given RLH's deep involvement in the strategy, day-to-day operations, and a number of the bad acts described in the complaint may explain why the PE firm was named as a defendant.

Examples of Potential FCA Exposure for PE Firms

Medrano suggests that PE firms may be exposed to allegations of FCA liability when they are closely involved in a portfolio company's operations — especially if that involvement is connected to the portfolio company's alleged fraudulent conduct. However, FCA exposure is not limited to this type of situation.

Below are three examples of additional situations in which PE firms have FCA exposure. To be clear, these are only examples and FCA exposure could arise in other situations.

1. Successor Liability: Conduct That Occurred Before a PE Firm's Purchase of a Company

A PE firm may face FCA exposure when it purchases a portfolio company that has violated the FCA, even if the violation occurred prior to the acquisition. The scope of this exposure is jurisdiction-dependent, as courts have applied different tests to determine whether a company acquiring the assets of another assumes the acquired company's liabilities as well.

In 2016, the Fourth Circuit became the first US Court of Appeals to address the application of successor FCA liability to the purchaser of a government contractor. The opinion in *United States ex rel. Bunk v.*

Government Logistics N.V.[15] provides significant guidance for determining whether the purchaser in an asset transaction also assumes liability for potential FCA violations committed prior to the acquisition.

In *Bunk*, the whistleblower alleged collusion among defendants to inflate bids for government contracts by the primary defendant — the Gosselin Group N.V. — over a 15-year period. During this period, the Gosselin Group sold the assets used to perform these government contracts to an unrelated purchaser, Government Logistics. In 2008, the relator and the government filed complaints naming Government Logistics as a defendant, alleging that Government Logistics was jointly liable for the underlying fraud. The District Court granted summary judgment in favor of Government Logistics,[16] and the relators[17] appealed to the Fourth Circuit.

The Fourth Circuit reversed the District Court's decision and rebuffed relators' attempt to expand successor liability under the FCA beyond common law principles. While the Fourth Circuit allowed the whistleblowers to proceed against Government Logistics under the so-called "fraudulent transaction" exception to successor liability — which "turns on the intention underlying the transfer of assets to [the new company], i.e., whether it was made with an actual intention to hinder, delay, or defraud creditors"[18] — the court ruled that the more easily-satisfied substantial continuity theory exception does not apply to FCA claims because it is not explicitly addressed in the statute.[19]

A key lesson of *Bunk* is that, while successor liability under the FCA may be limited, an entity acquired by a PE firm — or an entity owned by a PE firm that acquires the assets of a government contractor — may face potential FCA liability under certain circumstances based on actions that occurred prior to the PE firm's acquisition.

2. Inaccurate Small Business Certifications: If a Portfolio Company Incorrectly Represents as a Small Business

When a PE firm acquires a company that previously represented itself as a "small business," the PE firm and portfolio company need to consider carefully whether the company can continue to claim small business size status after the acquisition.[20] There are rules of "affiliation" under which the Small Business Administration determines whether an entity qualifies as a small business concern by counting its receipts, employees, or other measures, including its domestic and foreign affiliates regardless of whether the affiliates are for profit. The PE firm's acquisition of a company may result in affiliation of that company with the PE firm and the PE firm's other portfolio companies.[21] Depending on the size of the PE firm and its other portfolio companies and the applicable small business size standards, a company that once claimed small business size status may no longer qualify as a small business as a result of the acquisition.

Failing to recognize a loss of small business status can have significant consequences. A company improperly claiming status as a small business has exposure under the FCA and other procurement fraud laws. Moreover, the Small Business Jobs Act — which requires contractors to certify their small business size and status on an annual basis on the government's System for Award Management (SAM) website — provides that improper size certifications will be deemed to be "affirmative, willful, and intentional" acts and creates a presumption that damages to the government are the entire value of the contract.[22]

3. Unallowable Management Fees: If a PE Firm Charges Management Fees to a Portfolio Company Found to Be Unallowable Under the FAR

PE firms often provide management services to their portfolio companies and charge the portfolio companies for those services. When the portfolio company holds cost-reimbursement government contracts, it often includes these management fees in its request to the government for cost reimbursement. Management fees may qualify as "professional and consultant services" and may be allowable under FAR 31.205-33.[23] However, it is not uncommon for the government to audit a contractor's cost proposals and submissions to determine if they are in fact allowable under FAR Part 31.

If a government audit determines that some or all of the claimed management fees were improperly included in the portfolio company's reimbursement requests, the portfolio company may be liable for improperly charged costs. And, in some cases, the portfolio company's claims for reimbursement may be considered false claims under the FCA. In extreme situations, DOJ also might seek to impose FCA liability on the PE firm depending on the firm's involvement in any misconduct. While the portfolio company will ultimately be responsible for submitting the management fee costs to the government in accordance with FAR Part 31, PE firms can mitigate any issues by ensuring that any management fees they charge their portfolio companies align with FAR 31.205-33.

Practical Pointers for PE Firms to Mitigate the Risk of FCA Exposure

Though the long-term implications of *Medrano* are unknown, PE firms should take note of DOJ's decision to intervene against a PE firm in this case and examine their policies and procedures related to management of their portfolio companies that hold government contracts.

In doing so, PE firms should remain mindful that a variety of circumstances may give rise to FCA exposure — including, but not limited to, deep involvement in the direct day-to-day management of a portfolio company's business. To mitigate the risks of potential FCA liability, PE firms should consider the following steps when purchasing, managing, and selling portfolio companies that hold government contracts.

1. **Understand the nature of the portfolio company's government contracts:** PE firms should identify the types of government contracting performed by the portfolio company, the dollar value of the portfolio company's government contracts, the characterization of the portfolio company as either prime contractor or a subcontractor, and the government agencies involved in the contracts, among other facts. This type of knowledge will help the PE firm understand the risks associated with the portfolio company's government contracts business and the potential for FCA liability.

2. **Carefully consider the level of control the PE firm has over a portfolio company performing government contracts:** As a general practice, PE firms monitor their investments in portfolio companies; however, they also need to decide how to strike a proper balance between monitoring and becoming deeply entrenched in the day-to-day management of the portfolio company and/or its government contracting business.

3. **Check for ongoing government investigations and audits:** PE firms should be aware of any ongoing government investigations or audits of the portfolio company's government contracts that could result in potential FCA liability.

4. **Confirm compliance with federal procurement requirements to limit FCA exposure:** PE firms should ensure that the portfolio company has implemented policies and procedures regarding compliance with federal procurement requirements, including requirements related to small business size certifications and the submission of management fees to the government for cost reimbursement.

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Endnotes

1 Complaint, *United States ex rel. Medrano v. Diabetic Care Rx, LLC,* No. 15-cv-62617 (S.D. Fla. Feb. 16, 2018).

[2] *See* Press Release, Department of Justice, *United States Files False Claims Act Complaint Against Compounding Pharmacy, Private Equity Firm, and Two Pharmacy Executives Alleging Payment of Kickbacks* (Feb. 23, 2018), https://www.justice.gov/opa/pr/united-states-files-false-claims-act-complaint-against-compounding-pharmacy-private-equity.

[3] 31 U.S.C. §§ 3729.

[4] *See* Press Release, Department of Justice, *Justice Department Recovers Over $3.7 Billion From False Claims Act Cases in Fiscal Year 2017* (Dec. 21, 2017), https://www.justice.gov/opa/pr/justice-department-recovers-over-37-billion-false-claims-act-cases-fiscal-year-2017.

[5] 31 U.S.C. §§ 3733, 3730.

[6] *See* Civil Monetary Penalties Inflation Adjustment, 83 Fed. Reg. 3944, 3945 (Jan. 29, 2018).

[7] 31 U.S.C. § 3729(a)(1)(B) (emphasis added). In *Allison Engine Co.v. United States ex rel. Sanders*, 553 U.S. 662 (2008), the US Supreme Court held that establishing subcontractor liability under the FCA requires specific evidence that the subcontractor intended to make a false statement for the purpose of inducing payment from the federal government on a false claim. In 2009, Congress amended the FCA to specifically allow for subcontractor liability even where the subcontractor did not have the specific intent to make a false statement for the purpose of inducing payment from the government on a false claim. As long as the subcontractor causes a false statement or record to be used or made — regardless of whether the subcontractor knows the prime contractor will submit the false statement or record to the government for payment — the subcontractor may be liable under the FCA.

[8] *See, e.g., United States ex rel. Marsteller v. Tilton*, 880 F.3d 1302 (11th Cir. 2018) (vacating the judgment of the district court and remanding for further proceedings regarding whether the relators in non-intervened case naming Patriarch Partners, LLC, the private equity firm that owned the defendant company MD Helicopters, Inc.).

[9] Complaint 1-2, *United States ex rel. Medrano v. Diabetic Care Rx, LLC*, No. 15-cv-62617 (S.D. Fla. Feb. 16, 2018), ECF No. 36.

[10] *Id. at* 3, 9-10.

[11] *Id.* at 10.

[12] *Id*. at 3, 11. Matthew Smith, the company's Vice President for Operations is also named as an individual defendant. No individuals from RLH were named as defendants.

[13] *Id.* at 11.

[14] *Id.* at 12.

[15] 842 F.3d 261 (4th Cir. 2016).

[16] *Id*. at 271.

[17] The government initially filed an appeal but subsequently dismissed it and appeared as amicus. *See id.* at 272 n.13.

[18] *Id.* at 276 (explaining that the "fraudulent transaction" exception "turns on the intention underlying the transfer of assets to [the new company], i.e., whether it was made with an actual intention to hinder, delay, or defraud creditors").

[19] The substantial continuity exception applies when the purchaser has notice of the potential liability prior to the sale and continues in the seller's general business operations (as determined by analyzing a number of factors). *See, e.g., United States v. Carolina Transformer Co.*, 978 F.2d 832, 838 (4th Cir. 1992); *EEOC v. G-K-G, Inc.*, 39 F.3d 740, 748 (7th Cir. 1994).

[20] 13 C.F.R. § 121.103. The SBA's affiliation regulations regarding the Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs are located at 13 C.F.R. § 121.702.

[21] "Generally, affiliation exists when one business controls or has the power to control another or when a third party (or parties) controls or has the power to control both businesses. Control may arise through ownership, management, or other relationships or interactions between the parties." Small Business Compliance Guide Size and Affiliation at 5 (Mar. 2014) https://www.sba.gov/sites/default/files/articles/affiliation_ver_03.pdf.

[22] 15 U.S.C. § 632(w)(2) (The submission of a bid or proposal on a federal government contract or subcontract or registering in a federal contractor database as a small business concern is deemed to be "affirmative, willful, and intentional").

[23] FAR 31.205-33(c).