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Private Equity Firms Face Increasing False Claims Act Scrutiny

This summer, the U.S. Department of Justice announced a $15.3 million settlement with medical testing company Alliance Family of Companies LLC, resolving claims brought under the False Claims Act, 31 U.S.C. §§ 3279 *et seq.*[1] Notably, the Justice Department also reached a $1.8 million settlement with Alliance Family's minority owner, the private equity firm Ancor Holdings LP, based on allegations that it discovered the alleged activity of its portfolio company during diligence but took no actions to stop it. This settlement joins a number of False Claims Act cases brought against private equity firms based on their involvement with or ownership of portfolio companies. We expect such cases to become an increasingly regular feature of False Claims Act practice as private equity firms continue their investment in the healthcare space and the Department of Justice increases its scrutiny of Medicare and other government data to identify potential claims.[2]

In this Client Alert, we review the actions and practices relators, state attorneys general and the Justice Department argue give rise to liability on the part of private equity firms. This conduct includes the discovery of allegedly unlawful activity during diligence coupled with a failure to stop the activity and the taking of actions as involved owners that incentivize allegedly unlawful activity by the portfolio company. We also discuss factors private equity firms should consider to mitigate their False Claims Act risk.[3]

The False Claims Act

The federal False Claims Act ("FCA") is a Civil War-era law that allows private persons to file lawsuits on behalf of the federal government. These lawsuits are called *qui tam* suits, and the plaintiffs are referred to as "relators." The government has the option of intervening in the lawsuit and assuming primary responsibility for the litigation. Other times, the government may decline to intervene in the case, and the relator is responsible for prosecuting the action.

The two most commonly utilized provisions of the FCA impose civil liability for making false claims or for making false statements in connection with a claim. The false claims provision creates liability for any individual or entity that knowingly presents, or causes to be presented, to the government a false or fraudulent claim for payment. 31 U.S.C. § 3729 (a)(1)(A). The false statements provision imposes liability for any individual or entity that knowingly makes or uses, or causes to be made or used, a

[1] The settlement resolved six cases filed in the U.S. District Court for the Southern District of Texas: *United States ex rel. Mandalapu* v. *Alliance Family of Companies Inc.*, No. 17-cv-00740; *United States ex rel. Fuller* v. *Respiratory Sleep Solutions*, No. 17-cv-01197; *United States ex rel. Calcanis* v. *Alliance Family of Companies Inc.*, No. 19-cv-1497; *United States ex rel. Jane Doe* v. *Alliance Family of Companies LLC*, No. 19-cv-1213; *United States ex rel. McKay* v. *Alliance Family of Companies LLC*, No. 18-cv-1949; and *United States ex rel. Krasnov* v. *Alliance Family of Companies LLC*, No. 19-cv-4886. As of September 15, the dockets for these cases remain sealed.

[2] In a February 2021 speech, Acting Assistant Attorney General Brian Boynton noted that "the Civil Division has increasingly been undertaking sophisticated analyses of Medicare data to uncover potential fraud schemes." We have additionally covered the use of the FCA by the Justice Department to recover monies associated with COVID-19 relief.

[3] For a fuller explanation of the FCA and its elements, see our May 2020 Client Alert, *False Claims Act Liability in the Age of COVID-19*.

false record or statement in connection with such a claim. § 3729 (a)(1)(B).[4] A "claim" is broadly defined as a request or demand for money that may be made directly or through an intermediary, and the term "knowingly" only requires defendants to know the claim, statement, or record in question is false, deliberately ignore its falsity, or act in reckless disregard of its falsity — the Act requires no specific intent to defraud. § 3729(b)(1), (2).

Defendants are liable for up to treble damages relative to the loss experienced by the government, in addition to a monetary penalty of approximately $12,000 to $24,000 for every false claim. *See* § 3729(1); 15 C.F.R. § 6.3(a)(3). Relators are encouraged to bring *qui tam* suits because they stand to earn 15% to 30% of the amounts recovered by the government, plus attorneys' fees. *See* 31 U.S.C. § 3730(d). In the most recent reporting year, the Justice Department announced that it had recovered $2.2 billion in FCA cases in fiscal year 2020, with over $1.8 billion of the haul stemming from FCA litigation involving the health care industry. Drug and medical device manufacturers, hospitals, pharmacies and other health care companies are frequent targets for *qui tam* lawyers given the enormous federal reimbursement payments as part of the Medicare and Medicaid programs.

Allegations of FCA Liability Against Private Equity Firms

As FCA plaintiffs have increasingly targeted private equity firms, they have made common allegations regarding, *first*, the scienter and knowledge of the firms and, *second*, how their conduct could be construed as causing the alleged false claims.

Scienter & Knowledge

When attempting to hold private equity firms liable under the FCA, relators and the government must first show the firm was aware of the allegedly unlawful conduct. In practice, they do so by showing reports brought to the attention of the firm during due diligence preceding the firm's acquisition of the target company and/or during the oversight of the portfolio company.

For example, in the *Alliance Family* settlement, the Justice Department alleged that the medical testing company had engaged in a kickback and fraudulent billing scheme. According to the settlement, physicians and other health care providers refer their patients to Alliance to receive testing. As part of the alleged scheme, Alliance developed a network of referring physicians by paying independent contractors to interpret the tests, and then providing those interpretations to referring physicians for free. This allowed referring physicians to bill for interpreting the tests without actually having to perform the interpretation themselves. Additionally, the independent contractors would promise to order EEG tests for their own patients from Alliance. The Justice Department additionally alleged that Alliance billed government insurance programs for procedures it did not perform. The Justice Department ultimately argued that the private equity minority owner, Ancor, was aware of the actions of Alliance because it learned of this conduct during the diligence process prior to Ancor's investment.

Similarly, in *United States ex rel. Martino-Fleming* v. *South Bay Medical Health Centers*, the state of Massachusetts alleged after intervening that the diligence by a private equity firm of an outpatient mental health provider uncovered documentation issues and poor supervision. *See* No. 15-CV-13065, 2021 WL 2003016, --- F. Supp. 3d ---- (D. Mass. May 19, 2021). When arguing against a motion for summary judgment by the firm, Massachusetts pointed to reports from the Chief Clinical Officer directly to the private equity sponsor's employees detailing supervision issues. The district court, denying the motion for summary judgment, held that these reports, coupled with the private equity firm's knowledge of the procedures of billing the federal government, created a factual question concerning whether the firm knew of the compliance issues this lack of supervision had created. Shortly after the motion was denied, the court entered an administrative stay of the case pending settlement discussions.

[4] The FCA also imposes civil liability for conspiracy to violate the FCA, which is analyzed under traditional civil conspiracy principles. *See United States ex rel. Westmoreland* v. *Amgen, Inc.*, 738 F. Supp. 2d 267, 280 (D. Mass. 2010) (holding that general civil conspiracy principles apply to FCA conspiracy claims).

Causation & Control
As noted above, FCA liability requires proof that the defendant caused the presentation of a false claim to the government. A review of the recent cases shows that relators argue that private equity owners caused their portfolio companies to violate the FCA based on a variety of actions or omissions.

The most common allegations in this regard are that the private equity firm "caused" portfolio company actions either through control of board seats or payments to the firm for involvement with the portfolio company. For example, in *United States ex rel. Medrano* v. *Diabetic Care RX, LLC*, the Justice Department alleged that the partners of the private equity owner of a pharmacy became officers and/or directors of the portfolio company and its manager, directing the company's entry into the market at the center of the alleged kickback scheme and supervising the pharmacy's CEO during its execution. *See* First Am. Compl. in Intervention, No. 15-62617-CIV (S.D. Fla. Mar. 18, 2019).[5] And, in the above-discussed *Alliance Family* cases, the Justice Department alleged that Ancor had control over Alliance because it managed the testing provider through a management services agreement, in addition to holding a minority of board seats. Based on these facts, the Justice Department alleged Ancor had allowed the unlawful activity to continue after its acquisition of the testing provider.

Qui tam plaintiffs also argue that owners cause the allegedly unlawful acts of their portfolio companies by incentivizing and enabling aggressive sales and billing practices. In *Diabetic Care*, the private equity owner of the pharmacy provided funding to its portfolio company to pay commissions to marketers, who were allegedly paying telemedicine doctors to prescribe the pharmacy's products without a proper review of patients' needs. The Justice Department alleged that these marketers were part of a kickback scheme to sell and bill for topical pain creams, and that the owner's funding of commissions caused fraudulent billing. Similarly, in *United States ex rel. Johnson* v. *Therakos, Inc.* relators argued that the owner of a pharmaceutical and medical device company was liable for fraudulent billings based on sales pressure it placed on the portfolio company. Third Am. Compl., No. 12-cv-01454 (E.D. Pa. Dec. 14, 2016).[6]

Finally, plaintiffs frequently argue that merely knowing about but declining to stop allegedly unlawful conduct is sufficient to confer liability on a private equity firm for the actions of its portfolio company. When the *Martino-Fleming* court found factual disputes concerning liability, it looked to evidence of the private equity firm's failure to stop fraudulent billing practices, despite knowing of them (as discussed above) and having the ability to stop them by virtue of holding board seats. The *Therakos* relators went further, alleging that private equity owners were liable merely because the allegedly fraudulent conduct continued during their ownership and with their knowledge.

Factors to Consider

Private equity firms considering an investment into companies that receive government funds must be especially cautious when conducting diligence and ultimately overseeing such companies. To limit exposure to FCA lawsuits, firms should keep the following factors in mind:

- **Remediate Potential Problems.** When credible and material concerns regarding compliance reach firm employees, during pre-acquisition due diligence or otherwise, firms should consider engaging outside counsel to fully investigate such claims. Early identification of issues can lead to quick development of solutions before substantial liability can accrue, and, based on the circumstances and the advice of counsel, outreach to government officials with investigation findings can potentially ease the litigation process.

5 In September 2019, the Justice Department announced the pharmacy and its private equity owner jointly agreed to pay $21.1 million to settle all claims.

6 In November 2020, the Justice Department announced the company agreed to pay $10 million to settle claims, with former private equity firm owner The Gores Group agreeing to pay an additional $1.5 million.

- **Continually Focus on Compliance.** After completing the acquisition of a target, firms should continue to evaluate and improve compliance systems. Firms should invest in robust reporting systems that surface deviations from compliance standards, as well as procedures for evaluating and improving safeguards.

- **Ensure Compliance Keeps Up with Sales Pressure.** When portfolio companies implement new sales strategies and processes, they should in parallel invest in compliance functions. A focus on improving performance can result in errors and miscommunications that could result in liability later. Investing in both tracks can improve sales performance while limiting exposure to FCA lawsuits later.

- **Be Intentional about Involvement with Portfolio Companies.** When determining the level of involvement it will take in the day-to-day operations of a portfolio company, firms should balance the benefits to growth and performance such involvement could bring against potential FCA exposure. Considering the above factors and consulting with counsel regarding potential liability can ensure an appropriate balance.

We will continue to monitor developments in this space.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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