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In Recent Healthcare Fraud Lawsuit, the U.S. Department of Justice Embraces a More Expansive View of Private Equity Firm Liability for Portfolio Company Conduct

In February, the DOJ intervened in *United States ex rel. Medrano v. Diabetic Care RX, LLC*, No. 15 Civ. 62617 (S.D. Fla.), a False Claims Act case involving alleged healthcare fraud. The complaint in intervention asserted claims against a compounding pharmacy, its executives and, notably, the manager of a private equity fund that owned the pharmacy. While the activities of the private equity manager in the case were particularly intertwined with those of the portfolio company, much of the conduct cited is not atypical for private equity firms. The DOJ's decision to intervene signals a possibly more expansive view of manager liability for portfolio company conduct and is thus an instructive reminder for private equity managers to exercise particular care to the extent they become deeply involved in portfolio company operations and management.

The case, originally brought in 2015 by two former employees of Diabetic Care RX, relates to claims for compounded drugs submitted to TRICARE, a U.S. government program which provides healthcare for active duty and retired military personnel and their dependents. As alleged in the DOJ's complaint,¹ Diabetic Care RX, now doing business as Patient Care America (PCA), violated the False Claims Act by paying kickbacks in the form of commissions to outside marketing companies that generated prescriptions for pain and scar creams and vitamins, that in turn were filled by PCA and submitted to TRICARE for reimbursement.

The DOJ further alleges that certain of these prescriptions were written by doctors who had not seen the patients on whose behalf the prescriptions were filled; that certain prescriptions were not based on patients' legitimate medical needs; and that PCA manipulated the ingredients in the medicines it compounded to maximize its TRICARE reimbursements. Finally, the DOJ alleges that PCA and an outside marketing company used a fraudulent non-profit to cover the cost of certain patient co-pays without regard for actual financial need.

For the private equity industry, the PCA complaint is noteworthy because of the defendants named in the case. In addition to PCA, PCA's CEO and a former PCA executive, the DOJ sued a California-based private equity firm (the "Private Equity Manager"). According to the complaint, a fund managed by the Private Equity Manager made a controlling investment in PCA in 2012, and "[the Private Equity Manager]

¹ Complaint in Intervention, *United States ex rel. Medrano v. Diabetic Care RX, LLC*, No. 15 Civ. 62617 (S.D. Fla. Feb. 16, 2018), D.E. 36.

managed and controlled PCA on behalf of the private equity fund through two [of the Private Equity Manager's] partners . . . who served as officers and/or directors of PCA and of a holding company with an ownership interest in PCA."²

The complaint includes a number of factual allegations about the Private Equity Manager's control over, and knowledge of the activities of, PCA. While many of these allegations appear to be intended to demonstrate the Private Equity Manager's knowledge of and involvement in the conduct at issue in the case, through involvement in PCA's day-to-day operations, some of the DOJ's allegations highlight relatively common industry practices, including having a private equity firm's partners serve as portfolio company board members, playing a role in selecting portfolio company management and implementing internal controls over portfolio company spending.

- **Investment Horizon:** The complaint attributes significance to the Private Equity Manager's acquisition of PCA with the express goal of increasing PCA's value and then exiting the investment, alleging that "[a]t the time [PCA] was acquired, [the Private Equity Manager] planned to increase [PCA's] value and sell it for a profit in five years,"³ which is hardly an unusual objective for a private equity manager. As alleged in the complaint, shortly after the Private Equity Manager acquired PCA, Medicare changed its reimbursement rates for PCA's primary source of revenue, after which "[r]estoring [PCA's] profitability became [the Private Equity Manager's] primary objective."⁴
- **Selection of Portfolio Company Management:** The complaint alleges that PCA's CEO, a co-defendant in the case, was hired based on the recommendation of a Private Equity Manager partner despite warnings from an executive search consultant that the CEO would "require more careful management than [the Private Equity Manager] may wish to provide."⁵ The complaint also includes a number of allegations about the Private Equity Manager's role setting the CEO's compensation, and notes that PCA management was subject to internal controls on spending. For example, as alleged in the complaint, "[the Private Equity Manager] expected [PCA's CEO] to consult with [the Private Equity Manager's] partners before entering into any type of contract that obligated the company to make annual payments over \$50,000.00 or total payments over \$150,000.00."⁶
- **Role Setting Portfolio Company Strategy:** The complaint alleges that two of the Private Equity Manager's partners, in their capacities as PCA board members, "led the pain management initiative"

² *Id.* ¶ 6.

³ *Id.* ¶ 40.

⁴ *Id.*

⁵ *Id.* ¶ 48.

⁶ *Id.* ¶ 50.

at PCA, which resulted in the alleged kickbacks.⁷ According to the complaint, which includes purported quotations of statements by the Private Equity Manager’s partners, these partners worked to “generate a ‘very fast payback on [the Private Equity Manager’s] investment’” at the risk of “cross[ing] the line from an ethics standpoint.”⁸

- **Receipt of Portfolio Company Financial Information:** The complaint alleges that the Private Equity Manager regularly received detailed financial and operational information from PCA. For example, the complaint asserts that PCA’s board members, including two of the Private Equity Manager’s partners, received monthly financial statements, which allegedly reflected the challenged payments to outside marketing companies.⁹
- **The Private Equity Manager’s Transfers of Funds to PCA:** As alleged in the complaint, the Private Equity Manager transferred funds to PCA to cover commission payments despite “kn[owing] that the money it was providing to PCA was to be used to pay commissions to the marketers.”¹⁰

The defendants, including the Private Equity Manager, deny the allegations in the complaint, and there has been no determination of liability.

The DOJ’s complaint, which reflects a coordinated investigation by five U.S. government agencies, is noteworthy in several respects.¹¹ From a U.S. regulatory perspective, the DOJ’s complaint may represent significant further development in a recent trend involving attempts to hold private equity managers liable for portfolio company conduct. In recent years, civil litigants have pursued a variety of different theories of private equity firm liability, including claims under U.S. employment regulations such as the WARN Act and the Employee Retirement Income Security Act of 1974, control person liability and aiding and abetting liability, with varying degrees of success.¹² From an international legal perspective, the

⁷ *Id.* ¶ 42.

⁸ *Id.* ¶¶ 44–45.

⁹ *Id.* ¶ 81.

¹⁰ *Id.* ¶ 83.

¹¹ See Dep’t of Justice, Office of Public Affairs, *United States Files False Claims Act Complaint Against Compounding Pharmacy, Private Equity Firm, and Two Pharmacy Executives Alleging Payment of Kickbacks*, Feb. 23, 2018, available at <https://www.justice.gov/opa/pr/united-states-files-false-claims-act-complaint-against-compounding-pharmacy-private-equity>.

¹² See, e.g., *Guippone v. BH S&B Holds., LLC*, 737 F.3d 221 (2d Cir. 2013) (allowing claim to proceed against parent holding company for closely held subsidiary’s alleged violations of WARN Act); *Sun Capital Partners III, LP v. N.E. Teamsters & Trucking Indus. Pension Fund*, 724 F.3d 129 (1st Cir. 2013) (discussing potential “trade or business” status of private equity firm for ERISA purposes); but see *In re Jevic Holding Corp.*, 656 F. App’x 617 (3d Cir. 2016) (finding that private equity firm and bankrupt subsidiary were not a joint employer for WARN Act purposes).

complaint is consistent with increasing efforts by regulators in other jurisdictions to hold private equity firms liable for portfolio company conduct using evolving legal theories. These efforts include recent proceedings by EU and Dutch competition authorities and an increased focus on potential environmental and antibribery liability.

Private equity fund managers and their counsel should consider monitoring future developments in the PCA litigation, which may provide additional insight into and guidance regarding regulatory scrutiny of the private equity industry.

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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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