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False Claims Act Alert

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Key Points

- In an unusual move, the government has decided to pursue a False Claims Act (FCA) suit against a private equity firm based on an alleged commission scheme at its pharmacy portfolio company to promote sales of products subject to federal reimbursement.
- The inclusion of the private equity firm as a named defendant in the Complaint may indicate an increased willingness by the government to pursue the investment management firms backing health care companies and other entities that receive federal funds.
- The FCA sets a high bar to establish that company owners or directors knowingly caused the presentment of false claims. The Complaint thereby provides insight into the level of participation in the operations of a portfolio company the government deems sufficient to pursue a private equity firm for the alleged misconduct of its portfolio company. The case also provides insight into steps private equity firms should take to reduce their potential exposure to liability under the FCA.

United States Intervenes in Suit Against Private Equity Firm Based on Health Care Portfolio Company's Alleged False Claims Act Violations

Background

In December 2017, the United States intervened in a qui tam suit relators Marisela Carmen Medrano and Ada Lopez filed against defendants Diabetic Care RX, LLC d/b/a Patient Care America ("Patient Care"), a pharmacy organized under Florida law; Patrick Smith and Matthew Smith, two Patient Care executives; and Riordan, Lewis & Haden, Inc. (RLH), a private equity firm holding a majority interest in Patient Care. In its Complaint in Intervention, filed February 16, 2018, the government alleges that the defendants defrauded the United States of approximately $85 million through a scheme in which Patient Care provided illegal commissions to independent marketers to refer patients for compound drug prescriptions reimbursed by TRICARE in violation of the FCA and the Anti-Kickback Statute.

The FCA imposes liability on any person who "knowingly presents, or causes to be presented, a false or fraudulent claim for payment or approval" or who "knowingly makes, uses, or causes to be made or used, a false record or statement material to a false or fraudulent claim." 31 U.S.C. § 3729(a)(1)(A)–(B). The Anti-Kickback Statute prohibits the knowing and willful solicitation or receipt of any remuneration in

exchange for the referral of federal health care business. 42 U.S.C. § 1320a-7b(b)(2). A claim that includes items or services resulting from a violation of the Anti-Kickback Statute "constitutes a false or fraudulent claim" under the FCA. 42 U.S.C. § 1320a-7b(g). Violations of the FCA are subject to treble damages and civil penalties of between $10,957 and $21,916 per claim.

Allegations

The government alleges Patient Care (previously operating as Diabetic Care RX, LLC) engaged in a kickback scheme through which it paid illegal commissions to independent marketing companies to refer patients for topical compound drug prescriptions reimbursed by TRICARE.

As part of this purported scheme, Patient Care allegedly manipulated the formulations of prescriptions to ensure the highest possible reimbursements, issued prescriptions without patient consent or a patient-doctor relationship, and coordinated with one of the marketing companies to cover the cost of patient copayments to induce additional prescriptions.

Although the allegations in the Complaint are not particularly unusual for a civil FCA enforcement case, the Patient Care action is notable because the government elected to pursue not only Patient Care and its individual officers, but also RLH, the private equity firm controlling Patient Care.

The government's allegations—to which the defendants have not yet had an opportunity to respond—provide that RLH acquired a controlling interest in Patient Care in 2012 with the intention of increasing Patient Care's value and selling the business for a profit within five years. RLH allegedly installed two of its partners as officers of Patient Care and as officers and board members of the company that then-managed Patient Care. The Complaint alleges that RLH directed Patient Care's entry into the topical compound drug business, required Patient Care's CEO to consult with RLH partners before entering certain contracts, and funded commission payments to marketers when they became due prior to Patient Care's receipt of TRICARE reimbursements.The Complaint does not allege that Patient Care is the alter ego of RLH.

Analysis

The government's decision to pursue the compounding pharmacy's private equity firm owner presents challenging issues with respect to the FCA's knowledge and causation requirements.

To establish FCA liability, the government or relator must show that the defendant "presented" or "caused to be presented" a false or fraudulent claim for payment or approval and that the defendant had actual knowledge of the claim's falsity or acted in deliberate ignorance or reckless disregard of its truth or falsity. 31 U.S.C. § 3729(a)(1)(A), (b)(1).

Typically, a company's owners and outside board members do not "present" any claims for payment or approval. The company itself, or its employees, actually "present" the claims. Thus, a company's owners or board members may be liable under the FCA only if they "caused" false claims to be presented. The

relevant question then becomes under what circumstances an owner or board member "causes" the presentment of false claims.

"Generally, mere knowledge of the submission of claims and knowledge of the falsity of those claims is insufficient to establish liability under the FCA." *United States ex rel. Sikkenga v. Regency Bluecross Blueshield of Utah*, 472 F.3d 702, 714 (10th Cir. 2006). A plaintiff must demonstrate that a party has taken an "affirmative action" that "cause[d] or assist[ed] the presentation of a fraudulent claim." *United States v. Stevens-Henagar College*, 174 F. Supp. 3d 1297, 1314 (D. Utah 2016) (quoting Sikkenga, 472 F.3d at 714–15). This requirement ensures that only FCA claims "against parties who can fairly be said to have caused a claim to be presented to the government" proceed, while "claims with only attenuated links between the defendants' specific actions and the presentation of the false claim" are barred. *United States v. Luce*, 873 F.3d 999, 1012–13 (7th Cir. 2017) (quoting *Sikkenga*, 472 F.3d at 714). Courts thus analyze a party's specific conduct to determine "whether that specific conduct cause[d] the presentment of a false claim." *Sikkenga*, 472 F.3d at 714.

Under this standard, there is often no basis to proceed against a company's private shareholder(s) or its representatives on a portfolio company board for the company's alleged FCA violations. This result is consistent with settled law regarding corporate separateness, the role and duties of outside corporate directors, and the standards under which they may be held accountable for failing to prevent wrongdoing by company management or employees.

Settled corporate law principles provide that, absent reason to suspect misconduct, outside directors may not be charged with wrongdoing "for assuming the integrity of employees and the honesty of their dealings on the company's behalf." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996). Outside directors fulfill their duty to prevent illegal conduct when they establish adequate information and reporting systems to keep the board informed of pertinent matters affecting the company and receive and rely on appropriate advice from inside and outside experts. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006). Outside directors are not expected to be experts with respect to every aspect of a business or to detect all errors in an expert's analysis or advice.

Liability limitations for outside directors and investment firms are consistent with important policy considerations underlying private capital investments in the health care industry. The health care industry, like many others, depends on private companies to deliver necessary products and services. Private companies, in turn, require the capital that private equity funds supply to sustain their operations and develop new and innovative ways to deliver those products and services. Pursuing private equity firms for the wrongdoing of their operating companies could have a chilling effect on future investments in the health care industry and could impair, rather than improve, the availability and variety of affordable, quality health care.

Conclusion

For private equity firms that invest in entities that do business with the federal government, the Patient Care case is instructive regarding the importance of robust due diligence with respect to potential

investments and careful compliance oversight throughout the life of the investment. The decision to pursue RLH as a named defendant indicates a potential shift in the government's willingness to sue private equity firms and other financial backers for alleged FCA violations involving their portfolio companies.

The government's Complaint further provides important guidance regarding the level of participation and knowledge the government has deemed sufficient to pursue a private equity firm for its alleged conduct underlying an FCA scheme. Apparently, the government concluded that some action—like installing partners as officers of the operating company and funding commission payments to independent marketers—was a sufficient "affirmative act" that "cause[d] or assist[ed] the presentation of a false claim." *Stevens-Henagar College*, 174 F. Supp. 3d at 1314.

Given the prospect of treble damages and substantial civil penalties, it is important that private equity firms minimize their exposure to potential FCA violations, especially where the firms are more deeply integrated into the operations of their underlying portfolio companies. Below are some guidelines that private equity firms can follow to minimize these risks when they have a controlling interest in, or a seat on the board of directors of, a portfolio company that derives a material portion of its revenue from the federal government:

- When promoting, approving, or funding a specific business initiative that relies on government payments, consult legal counsel in advance with respect to the legality of the related business plans.
- Require that all portfolio companies that do business with the federal government have internal compliance policies and procedures in place to guard against the risk of false or fraudulent conduct in the company's interactions with the federal government, that the board of directors regularly reviews those policies and procedures with management, that compliance reports are routinely prepared for the board, and that the board's discussion and review of such policies and reports is specifically referenced in the board minutes.
- If the nature or amount of government-related revenues undergoes a significant shift or change, request confirmation from the company's management of the company's compliance efforts tailored to such changes.
- Remain especially vigilant when a large portion of management compensation is variable and benefits from the volume or profitability of goods or services paid for by the government.

Taking appropriate steps will help protect a private equity firm from being named as a defendant in an FCA action and will prevent claims against the firm's underlying portfolio companies that could otherwise erode the value of the firm's investments.

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