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ALERT ▪ False Claims Act ▪ Private Equity

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Private Equity Firm Settles with DOJ in False Claims Act Matter Based on Claims Submitted by Its Health Care Portfolio Company

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Compounding pharmacy Diabetic Care Rx, LLC d/b/a Patient Care America ("PCA"), two individual executives, and the pharmacy's private equity fund owner, Riordan, Lewis & Haden, Inc. ("RLH") recently reached a $21 million settlement with the U.S. Department of Justice ("DOJ") to resolve allegations that the parties engaged in an illegal kickback scheme resulting in submission of false claims to the government in violation of the False Claims Act ("FCA").

Ropes & Gray previously issued an Alert on this lawsuit in 2018 following DOJ's then-unprecedented decision to intervene against not only the portfolio company that allegedly submitted false claims, but also against its private equity owner. The parties' $21 million settlement demonstrates the potential viability of DOJ's approach and highlights a risk that private equity firms may face, particularly when investing in portfolio companies in the health care space, where most FCA recoveries occur. This is a developing area of FCA exposure that Ropes & Gray will continue to monitor going forward.

Allegations in DOJ's Original Complaint and RLH's Involvement

As detailed in our March 2018 Alert, the allegations in *Medrano v. Diabetic Care Rx, LLC d/b/a Patient Care America et al.* (S.D. Fla. No. 15-62617-civ) stem from the defendants' decision to enter the compound pain cream business in early 2014. According to DOJ, TRICARE reimbursement rates for topical pain creams were known to be unusually high at the time, which allegedly prompted PCA to enter into a scheme with three marketing companies to target and refer TRICARE beneficiaries to PCA for pain cream prescriptions. The government alleged that the resulting prescriptions were medically unnecessary and that PCA's commission payments to the marketing firms amounted to illegal kickbacks under the Anti-Kickback Statute ("AKS"), which resulted in PCA's submission of false claims to TRICARE.

The government's February 2018 Complaint in Intervention also includes allegations that the marketers paid kickbacks to patients by covering patient copayments regardless of financial need, and that the marketers paid telemedicine physicians to write prescriptions without proper consent or a legitimate prescriber-patient relationship. Finally, the government included two common law claims for payment by mistake and unjust enrichment based on the same alleged misconduct.

With respect to private equity owner RLH, the government claimed that the firm played a leading role in promoting PCA's alleged misconduct. Two RLH partners served as directors of the portfolio company and allegedly encouraged its pursuit of the pain cream business to generate a "quick and dramatic payment" on the fund's investment. According to the government, RLH knew and approved of PCA's May 2014 decision to use independent contractors rather than employed sales staff to generate prescriptions for topical pain creams. Further, the Complaint in Intervention alleged that RLH knew based on the advice of counsel that paying commissions to marketers could violate the AKS and that compliance with the AKS was a material requirement for reimbursements from TRICARE. Based on this advice and on RLH's experience investing in the health care industry, the government argued that the private equity firm knew or should have known that PCA's practices violated federal health care laws.

Before Settlement, RLH Moved to Dismiss on the Grounds that DOJ Failed to Adequately Establish Its Knowledge and Causation of the Alleged Schemes

The defendants filed motions to dismiss the government's original Complaint in Intervention. PCA's argument centered on the government's failure to adequately plead that the claims submitted were knowingly false as required under the FCA. Meanwhile, RLH focused on the government's "unprecedented" attempt to impose FCA liability on a private equity firm for the wrongdoing of a portfolio company. RLH argued that the Complaint in Intervention failed to sufficiently establish that the firm knew of, participated in, or made any money from the fraud. RLH emphasized that the FCA requires both knowledge of a claim's falsity and an action by a defendant that causes the claim to be presented to the government. RLH maintained that the government failed to adequately plead these elements.

In March of 2019, a district court judge in the Southern District of Florida, in reliance on a magistrate's recommendation, dismissed the government's FCA claim without prejudice, holding that the allegedly false claims were not pleaded with the requisite specificity. Because the district court judge dismissed the FCA claim on these grounds, the decision did not reach the issue of RLH's knowledge and causation.

Notably, the magistrate judge did opine on RLH's argument that the government failed to adequately plead its knowledge and causation of the alleged schemes. Though ultimately rendered moot by the judge's order, the magistrate concluded that the government's allegations regarding the private equity sponsor's involvement were sufficient as to one of the three schemes, namely, the alleged commission payments to the marketing firm in violation of the AKS. The magistrate pointed to the government's allegations that RLH (i) approved of PCA's decision to use marketers to generate referrals; (ii) knew that TRICARE was the source of the majority of PCA's revenue; (iii) received monthly financial statements reporting the commissions paid to the marketers; and (iv) funded certain commission payments. The magistrate further highlighted the fact that RLH received legal advice regarding the risks of submitting claims to federal programs based on referrals from outside marketers.

DOJ filed an amended complaint several weeks after dismissal of the FCA claim, which the defendants followed with another round of motions to dismiss. Prior to a ruling, the parties announced the $21 million settlement with no determination or admission of liability.

Considerations for Private Equity Firms with Portfolio Companies in the Health Care Industry

While the settlement in *Medrano* does not create legal precedent, it nevertheless signals the potential viability of DOJ's new approach to recovering funds in the health care space by pursuing private equity owners under the FCA for claims submitted by their portfolio companies. In announcing the resolution, the government stated that the settlement demonstrates its "continuing commitment to hold all responsible parties to account for the submission of claims to federal health care programs that are tainted by unlawful kickback arrangements." This rhetoric suggests that DOJ's interest in looking to private equity sponsors in FCA cases is unlikely to wane.

Private equity companies should consider the following takeaways when investing in portfolio companies in industries with significant FCA exposure:

- Level of Involvement: *Medrano* provides some insight regarding how a firm's involvement in decisions at the portfolio company level may increase its risk of FCA exposure. In *Medrano* the private equity company was allegedly actively involved in PCA's decision to use marketers to generate referrals—the core misconduct in the government's complaint—and knew or should have known that the practices violated federal health care laws. While these allegations make *Medrano* an outlier, they nevertheless demonstrate that private equity sponsors should be mindful of their touchpoints with portfolio company operations and should document their areas of involvement. This will help firms avoid even the appearance of participation in any portfolio company misconduct.

  This is not to say that all touchpoints with a portfolio company increase a firm's risk, or that eschewing involvement altogether is an appropriate response to potential red flags. Rather, private equity companies should understand that they assume certain responsibilities when they participate in portfolio company decision-making and should fulfill those responsibilities by, for example, ensuring that personnel involved in portfolio company operations receive proper training and advice regarding the relevant risks.

- <u>Portfolio Company Compliance</u>: Private equity firms should assure that their portfolio companies operate appropriate compliance programs that address specific risk areas for their industry. This will mitigate the risk that portfolio companies engage in unlawful behavior. Appropriate portfolio company compliance programs help protect against penalties to the portfolio company itself, but may also help protect against a private equity sponsor's direct exposure. Private equity firm leadership on portfolio company compliance and training also helps establish a robust "tone from the top."

- <u>Advice of Counsel; Other Red Flags</u>: In *Medrano* the government alleged that the private equity sponsor failed to take appropriate actions in response to the advice of counsel with respect to illegal kickbacks. Private equity firms should be aware that their reaction to legal advice or similar red flags may be scrutinized and that declining to follow advice or ignoring warning signs may be used as evidence of intentional wrongdoing. Firms should carefully consider all potential red flags and should document the reasoning behind any decisions not to follow the advice of counsel. Documenting a thorough and thoughtful process for addressing known risks will help avoid the appearance that a private equity company intentionally ignored wrongdoing.