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VENABLE LLP

Wake-Up Call to Private Equity: Government Names PE Firm as Defendant in a False Claims Act Action

By: Kan Nawaday, Michael Blume, and Stephen Salsbury

In February, the Justice Department unsealed a False Claims Act (FCA) complaint against a compounding pharmacy (the "Complaint"). The Complaint alleges that the compounding pharmacy, Diabetics Care Rx LLC, defrauded TRICARE, the U.S. military's healthcare program, out of $68 million.

Sounds like a run-of-the-mill civil enforcement case, doesn't it? It's not.

In a rare move, the DOJ lawsuit also targeted Riordan Lewis & Haden Equity Partners (RLH), an LA-based private equity firm with a controlling stake in Diabetics Care. RLH currently has $1 billion in assets, and had managed other, similar healthcare companies at the time it took over Diabetics Care. The case should serve as a message to other private equity firms that have portfolio companies whose businesses rely on government contracts: you too could face the same FCA exposure as your portfolio companies.

As alleged in the Complaint, Diabetics Care Rx LLC, formerly known as Patient Care America (PCA), is a Florida-based compounding pharmacy founded in 2006. In 2012, RLH took a controlling interest in PCA. RLH's strategy was to increase PCA's value and sell the company for a profit within five years. In 2013, PCA's main source of revenue dried up when the government changed a Medicare reimbursement policy, forcing PCA to consider new ideas for growing the company's profitability. The government alleges that, in so doing, PCA hit upon an idea that was profitable but unlawful. That idea rested on a TRICARE policy that calculated insurance reimbursements on a per-ingredient basis. According to the government, PCA capitalized on the policy by tampering with the ingredients of its topical creams to boost reimbursements and using marketing firms to find more TRICARE patients. As a result, over a 12-month period, PCA saw its profits surge, driven overwhelmingly by TRICARE reimbursements for its new topical creams.

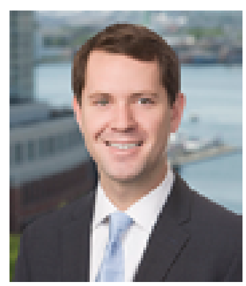
RLH's involvement was largely what you might expect from a PE firm. It took a controlling ownership and placed two of its partners on PCA's board. That alone should not be enough to target RLH for FCA liability. According to the government, however, three actions put the PE firm in the government's crosshairs. First, the Complaint alleges that RLH shepherded the company's entry into the world of compounding topical creams. According to DOJ's Complaint, the two RLH partners placed on PCA's board "led the pain management initiative." Second, one of the RLH partners was credited in the Complaint with selecting a new CEO for PCA, who was ultimately named co-defendant in the suit, despite warnings by a consultant about the CEO's shortcomings. Importantly, the CEO agreed to apprise RLH of significant decisions well before they were made. Third, RLH made some of the payments that form the basis for kickback allegations in the Complaint. As part of the scheme, the Complaint alleges that PCA worked extensively with a group of marketing companies to refer TRICARE patients in return for payments from PCA. RLH funded payments to the marketing partners when PCA was unable to pay because it was still waiting for reimbursement payments to come in. If true, such payments violated TRICARE policy prohibiting such referral schemes and, as alleged by DOJ, the anti-kickback statute, 42 U.S.C. § 1320a-7b(b)(2).

What does this mean for PE funds in general? For those that have portfolio companies that rely on government contracts, this could well mark a potential shift in attention toward controlling PE parents. DOJ does not publish information on how often it uses FCA actions to pursue claims against private equity firms, nor was it willing to comment in press articles about the practice. But this case shows that the government is not averse to holding PE firms to account for the wrongdoing of their portfolio companies. PE firms must recognize that the FCA is a powerful enforcement club that the DOJ has wielded to great effect over decades, and PE firms would be well advised to take steps to minimize the risk of becoming entangled in a high-stakes False Claims Act enforcement action. Among other things, PE firms must focus on compliance-related matters during their due diligence for any potential investment. They must maintain that focus during the life of their investment in any portfolio company. And the more involved they are in a portfolio company's management, the sharper that focus should be.

The private equity business model of adding value to portfolio companies through proactive control and oversight is a double-edged sword. This case is a reminder that the greater the oversight and control, the more mindful a PE fund must be to ensure that its portfolio companies are not running afoul of the law.

Kan Nawaday
Partner
+1 212.370.6240
kmnawaday@Venable.com

Michael Blume
Partner
+1 212.503.0699
msblume@Venable.com



Stephen Salsbury
Associate
+1 410.244.7470
stsalsbury@Venable.com