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Why the Justice Department is targeting private equity

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The U.S. Justice Department has since about 2016 included private equity firms as defendants in False Claims Act cases against healthcare companies. The department has received settlements in at least five such cases so far, and officials say to expect more in the future.

Before global private equity firm H.I.G. Capital bought a large Massachusetts mental health provider through an affiliate, its due diligence turned up warning signs that something fishy was going on. There were "documentation issues" and "poor quality of supervision."

That didn't deter H.I.G., which had about $21 billion in capital under management at the time. After the deal closed in 2012, three of its senior members joined the board of their new acquisition, South Bay Mental Health Center. But H.I.G.'s leaders didn't stop South Bay from using unlicensed clinicians across its 17 facilities, a practice that would culminate in more than $100 million in fraudulent Medicaid claims, according to a lawsuit H.I.G., its affiliates and executives paid $25 million to settle in October.

7 due diligence issues to avoid False Claims Act lawsuits

"There are individuals who came to this company who badly needed help with mental health issues," said Jeffrey Newman, the Boston attorney who represented the former South Bay employee who became a whistleblower. "There are people behind all this who are the victims in the end. That's missed in a case like this."

Private equity—a form of private financing where funds and investors buy directly into private companies—has shown an insatiable appetite for healthcare in recent years. Private equity deals in the U.S. healthcare sector surpassed $100 billion in 2018, compared with less than $5 billion in 2000. Not only is it a nearly $4 trillion industry with significant federal government support, U.S. healthcare has proven to be a reliable profit driver.

Proponents of the trend say private equity is an important player in healthcare because it has the capital needed to speed up technological advances and other innovations from what traditional operators can afford. Others argue private equity's business model—buy a company, boost profitability and resell for a hefty return—is incompatible with healthcare's mission.

Studies show less staffing, more surprise bills after private equity takeovers

The U.S. Department of Justice and state attorneys general are keeping a close eye on these deals. Healthcare has always represented an outsized share of the department's False Claims Act settlement proceeds—80% between 2017 and 2020—but it only recently—around 2016—began naming private equity firms as defendants in such cases against healthcare companies.

Since then, the federal government has won more than $43 million in settlement proceeds from private equity defendants across at least five such cases, and officials say to expect more cases in the future.

The DOJ has pledged to ramp up enforcement after billions of dollars in federal stimulus funding went toward supporting healthcare providers during the COVID-19 pandemic. Then-Principal Deputy Assistant Attorney General Ethan Davis said in a June 2020 speech that the DOJ will hold private equity firms accountable for their portfolio companies' actions, especially related to pandemic aid.

Court records and interviews show government watchdogs expect private equity firms to stop any fraud happening at their portfolio companies. They also show fraud at target companies—even ongoing lawsuits—aren't always a dealbreaker for private equity buyers, who in the most egregious cases even ramp up the schemes after taking over.

Private equity losing in addiction treatment investment

"There are ways to think about structuring around the (False Claims Act) risk," said John Bueker, a partner with Ropes & Gray who represents private equity clients. "But as an investor, it requires you to be more deliberate and thoughtful about it."

More investments, more investigations

There's no single policy or case federal prosecutors point to that explains the department's relatively new practice of suing private equity firms.

Rather, they say naming the private equity firm as defendants simply tracks with its increased presence in the sector.

"As long as private equity firms are incentivized to assume risk to create short-term, substantial profits in the healthcare sector, we're going to continue to see cases like this," said Charlene Fullmer, deputy chief of the civil division in the U.S. Attorney's Office for the Eastern District of Pennsylvania.

The False Claims Act relies on whistleblowers—also known as relators—bringing lawsuits against their employers, so the uptick in private equity defendants reflects more whistleblowers targeting them in their initial lawsuits that the DOJ later intervenes in, said Brian Roark, head of Bass, Berry & Sims' Healthcare Fraud Task Force.

"Generally relators will take a dollar from any pocket they can find," Roark said. "The driver is deeper resources to be able to pay judgments."

Among publicly available healthcare whistleblower cases, an estimated 82% of cases terminated with a likely settlement, according to data gathered by legal analytics firm Lex Machina. That figure includes stipulated settlements as well as voluntary dismissals by plaintiffs, which may indicate settlements, or the plaintiff dismissing the case for other reasons, said Ellen Chen, a legal data expert with Lex Machina.

Then-Deputy Attorney General Sally Yates pledged in a September 2015 memo that her department would focus on holding individuals accountable for corporate wrongdoing. She wrote that such accountability is important because it deters future illegal activity and incentivizes changes in corporate behavior.

Fullmer said the directive—issued during the Obama administration—refocused the department's efforts.

"If there are corporate officers and individuals who knowingly caused the fraud, we should be holding them accountable," she said.

Eight months after the Yates memo, the DOJ landed one of its first settlements with private equity firm Fortress Investment Group over healthcare false claims, Fullmer said. In that case, the whistleblowers, former managers of a retirement property, alleged a number of fraud schemes, including helping veterans or their surviving spouses submit false claims for veteran's benefits relating to aid and attendance. The defendants paid almost $9 million to settle the case.

The following year, the DOJ intervened in a case involving a private equity-owned compounding pharmacy, Patient Care America, which was accused of submitting claims to a veteran's healthcare program for pain creams using illegal kickbacks. Reimbursements allegedly ranged from $1,000 to $8,000 per prescription, with a gross profit margin of 90%.

"That's outrageous," said Steven Grover, the Fort Lauderdale, Florida, attorney who represented the whistleblowers in that case. "You can go to your neighborhood drug store and get a pain cream for $30."

DOJ v. PRIVATE EQUITY: A TIMELINE

The U.S. Justice Department has only recently begun including private equity owners as defendants in its False Claims Act lawsuits against healthcare companies. There have been a handful of examples since 2016, and an official said to expect more cases in the future.

THE CASES

☐ U.S. et al. v. Fortress Investment Group et al. / 13-cv-00314 MO

Click to view this case's details. () You can also hover or touch the ? tooltip for a shorter summary.

☐ U.S. ex rel. Medrano and Lopez v. Diabetic Care Rx d/b/a Patient Care America, et al. / 15-cv-62617

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☐ U.S. and the Commonwealth of Massachusetts ex rel. Martino-Fleming v. South Bay Mental Health Center; Community Intervention Services; H.I.G. Growth Partners; H.I.G. Capital; Peter J. Scanlon; and Kevin P. Sheehan / 15-CV-13065-PBS

Click to view this case's details. () You can also hover or touch the ? tooltip for a shorter summary.

☐ U.S. ex rel. Johnson et al. v. Therakos et al. / 12-cv-1454

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☐ Six qui tam lawsuits, including U.S. ex rel. Mandalapu et al. v. Alliance Family of Companies et al. / 4:17-cv-00740

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THE TIMELNE

Date	Event
9/9/2015	Yates memo released (PDF) (https://www.justice.gov/archives/dag/file/769036/download) outlining Justice Department's commitment to holding individuals accountable for wrongdoing.
? **4/29/2016**	DOJ intervenes in Fortress et al. One of the first examples of DOJ including private equity firm as defendant in False Claims Act lawsuit against healthcare company.
? **5/5/2016**	DOJ reaches $8.9 million settlement (https://www.justice.gov/usao-or/pr/united-states-recovers-over-8-million-false-claims-act-settlements-fraud-against-va-and) with Fortress Investment Group and Holiday Acquisition Corp.
? **12/15/2017**	DOJ intervenes in part and declines to intervene in part in Medrano and Lopez v. Diabetic Care Rx case.
? **1/9/2018**	Massachusetts attorney general intervenes in Martino-Fleming v. South Bay Mental Health Center et al.
? **9/18/2019**	DOJ reaches $21.4 million settlement (https://www.justice.gov/opa/pr/compounding-pharmacy-two-its-executives-and-private-equity-firm-agree-pay-2136-million) with private equity firm Riordan, Lewis & Haden and other defendants in Medrano v. Diabetic Care Rx case.
? **11/19/2020**	DOJ intervenes in Johnson et al. v. Therakos case, reaches $11.5 million settlement (https://www.justice.gov/usao-edpa/pr/former-owners-therakos-inc-pay-115-million-resolve-false-claims-act-allegations) with private equity firm The Gores Group and Johnson &

Johnson subsidiary Medical Device Business Services. Of the $11.5 million, Gores agreed to pay $1.5 million.

- **7/21/2021** DOJ reaches $15.3 million settlement (https://www.justice.gov/opa/pr/eeg-testing-and-private-investment-companies-pay-153-million-resolve-kickback-and-false) to resolve kickback and false billing allegations with Alliance Family of Companies. Of that, private investment firm Ancor Holdings will pay about $1.8 million.
- **10/14/2021** Massachusetts attorney general reaches $25 million settlement (https://www.mass.gov/news/private-equity-firm-and-former-mental-health-center-executives-pay-25-million-over-alleged-false-claims-submitted-for-unlicensed-and-unsupervised-patient-care) with private equity firm H.I.G. Capital, H.I.G. Growth Partners and two executives for their roles in Martino-Fleming case.

Source: Modern Healthcare research

Tricare paid the pharmacy $68 million for the creams between September 2014 and April 2015. That case ultimately settled for $21.4 million in 2019.

In a 2020 case, a Johnson & Johnson subsidiary paid $10 million to settle allegations that a former company, Therakos, illegally marketed a system that was Food and Drug

Administration approved for T-cell lymphoma in adult patients for other, unapproved uses in pediatric patients. Whistleblowers said more than 70% of Therakos' sales were for off-label uses. The FDA prohibits drugmakers from marketing and advertising for unapproved uses.

A private equity firm called The Gores Group bought Therakos in 2013 for an undisclosed amount, after the case was underway. Gores, which declined to comment, would later pay $1.5 million to settle allegations that the illegal sales and promotion practices continued under its watch. Gores sold Therakos to Mallinckrodt in 2015 for about $1.3 billion.

"The sales of this product weren't that great while it was owned by J&J," said the DOJ's Fullmer. "Private equity came in and turned an amazing profit in a fairly short amount of time."

The key ingredient: knowledge

If there's one key element the DOJ is looking for when investigating potential false claims, it's knowledge. The department has a case if there's evidence the private equity firm knew about the fraud and didn't do anything to stop it.

"The questions are: What did private equity know about that investigation and any alleged fraud at the time (the company) was acquired?" Fullmer said. "What due diligence was performed? And what was their role in the management and operations of the portfolio company?"

In cases where the DOJ won multimillion-dollar settlements against private equity firms, there was evidence the firms at least knew about the fraud. In some cases, there was evidence they were driving it.

In the compounding pharmacy case, for example, the judge determined that private equity owner Riordan, Lewis & Haden was not merely a passive investor that was aware of the fraud, but was "the motivating force" behind the compounding scheme, pointing to evidence that RLH leaders had conceived the idea and recruited the pharmacy's CEO.

In that case, the government found a document where an RLH principal had written that the scheme wouldn't last and that the goal was to generate a "very fast payback" on its investment to "make hay while the sun shines." RLH's leaders also sat on the pharmacy's board.

"Both sides engaged in a get rich quick scheme," Grover said.

The DOJ also showed a letter RLH had written to the pharmacy's CEO directing him to consult the firm prior to hiring and signing large contracts. "They were very involved," Grover said.

RLH said in a statement that it cooperated with the government and took proactive measures to ensure no similar issues in the future. It noted the case was settled with no admission of liability.

In the South Bay case, emails showed H.I.G. officials were made aware of the unlicensed clinicians. For example, in a 2016 email, an executive wrote to H.I.G. leaders that 70% of South Bay's supervisors were unlicensed and only 67% of clinic directors were independently licensed. Not only that, the H.I.G. leaders served as board members and the whistleblower said they were heavily involved in operational decisions.

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The Massachusetts Attorney General reached the $25 million settlement in the case. The U.S. DOJ declined to intervene, but will get a portion of the settlement because the federal government helps fund Medicaid.

In that case, the fraud was happening prior to H.I.G. taking over, but it also continued after the purchase, said Newman, the whistleblower attorney in the South Bay case.

Plaintiffs face a high bar for prevailing in False Claims Act cases: proving intentional, knowing fraud, he said.

"That doesn't happen unless you have factual evidence to support the claims," Newman said.

When Bueker advises private equity clients who are buying healthcare companies, that sometimes includes helping them navigate ongoing False Claims Act lawsuits. In one instance, the purchase price was adjusted to include his fees to litigate the case, in which the company ultimately prevailed.

To avoid liability in such situations, Bueker said he tells private equity clients to distance themselves from the company's day-to-day operations and information about its inner workings, as that could make them potentially vulnerable. He also suggests forgoing board seats, as that also could add False Claims liability, he said.

"There's a balance to be struck," Bueker said. "I think the advent of more cases being brought directly against the sponsors does lead sponsors to have to think about how they want to structure their relationship to portfolio companies."

Of course, that's not everyone's prerogative. Harry Eichelberger, founder and managing partner of Archimedes Health Investors, a healthcare focused private equity investment firm, said the first area of due diligence his firm looks to is billing and coding. Archimedes uses third-party coders that specialize in healthcare.

"If we find more than sloppiness but sometimes intentional upcoding or overcoding, we'll just shut down our discussions right there and save ourselves and the target the trouble of going through the rest of due diligence," he said. "It really is that much of a gating item for us in our due diligence process."

A common theme across the cases the DOJ has intervened in are private equity firms getting unusually involved in the day-to-day operations of their portfolio companies, Eichelberger said.

"To the extent the board and the private equity fund is reaching into the company to dictate how its operations are to be done, that's a sign of meddling on the part of the private equity firm or a sign that something is wrong at the company to begin with," he said.

That said, he doesn't characterize Archimedes' role in its portfolio companies as hands-off either. They always have board seats, which means they help set strategy, hire CEOs, set executive pay and put in place governance mechanisms, he said.

For private equity owners, a big motivator for clearing up any fraud at their portfolio companies is their plan to exit in three to seven years, said Peter Urbanowicz, managing director at Alvarez & Marsal and co-head of its healthcare industry group. They do that either by selling to another private equity fund, by taking the company public or by selling it to a publicly traded company. All of those options entail close inspections of the company's business practices.

"The level of scrutiny there is so high that when you buy into this investment as private equity, you want to start building those structures or enhancing those compliance structures if they don't already exist to really make them airtight," Urbanowicz said. "Same with financial controls. You really want to make them airtight."

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