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Limiting PE Firms' Exposure to FCA Liability for Alleged Misconduct by Portfolio Companies

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There are many concerns that can keep private equity (PE) firms' management teams up at night. Economic headwinds, geopolitical instability, and supply chain problems can change the fortunes of a PE firm and its portfolio companies seemingly overnight.

Unfortunately for those PE executives already struggling with these challenges, there's an increasingly prevalent concern rearing its ugly — and potentially costly — head: exposure to liability under the False Claims Act (FCA).

PE firms can be liable for their portfolio companies' misconduct under the FCA

Under the FCA, enacted in 1863 in response to federal defense contractor fraud during the Civil War, any person convicted of, or admits to, knowingly submitting false claims to the government is liable for up to *three times* the government's damages, along with an inflation-adjusted penalty. In addition, the FCA allows private citizens to file *qui tam* suits on behalf of the federal government against alleged wrongdoers. And there is a great incentive for purported whistleblowers to do so: A private citizen who is successful in his/her claim is entitled to receive a portion of the government's recovery. For this reason, the FCA and its *qui tam* suits have mobilized a legion of corporate whistleblowers who believe they can do well by doing good and calling out their current or former employers' alleged frauds.

Any company doing business with the federal government, whether by selling goods or services, potentially risks FCA liability. This includes portfolio companies of PE firms and, potentially, their owners. More specifically, any PE firm with an oversight role at a portfolio company via a board seat or management position may bear responsibility for the portfolio company's alleged wrongdoing, possibly even for acts done before the PE firm took an equity position in it.

A common misconception among PE owners is that commonplace practices in other industries are appropriate in the health care or life sciences industry. Indeed, standard business practice in most industries, such as treating a referral source to a fancy dinner or baseball game, can be perceived as an improper inducement in the health care industry. To that end, PE firms investing in health care companies must be well-versed in the complex regulatory structure governing those operating in health care.

So, how do PE firms best manage FCA risks in their health care portfolio companies? The following two strategies illustrate what actions firms can take to potentially reduce or eliminate that liability.

Strategy #1: Foster a culture of ethics and integrity at portfolio companies

PE firms should strongly consider implementing policies and processes for portfolio companies that can detect and prevent fraudulent conduct. But, most importantly, PE firms must instill a culture of ethics and integrity within their portfolio companies.

The benefit of this culture building is two-fold. First, it should help root out and expose any possible source of fraud or corruption. Second, if the DOJ ever investigates the PE firm, it will know if the company had both the intent and the culture to expose and correct any problematic behavior. This will hopefully signal that the alleged misconduct was limited to a single or small number of bad actors, and not an indication of a pattern or practice of fraud at the PE firm or its portfolio companies.

Instilling a culture of ethics and integrity requires leadership to do more than “talk the talk.” Indeed, true compliant leadership comes from the “tone at the top,” meaning that management must advocate and endorse the creation, publication, and implementation of its ethics and anticorruption policies and processes in formal programs, videos, handbooks, and other materials that clearly and forcefully explain what those policies are, why they exist, and the penalties for violating them. PE firms must be vigilant in maintaining a culture of compliance and integrity beyond the implementation of an effective compliance program.

For these reasons, it would be worthwhile during due diligence to interview a would-be portfolio company’s executives and in-house or external compliance personnel, including the chief compliance officer if relevant, to determine what kind of culture already exists at the company. That will determine the amount of work needed to establish an ethical company culture — or whether the culture is broken beyond repair and not worthy of your firm’s investment.

Strategy #2: Obtain indemnification from portfolio companies or insurance against FCA liability

Sometimes, the relationship between a PE firm and a portfolio company does not lend itself to one where building a culture, or even advising on building a culture, is feasible. In that situation, or when PE firms prefer to take a “belt and suspenders” approach to minimize potential FCA liability after engaging in culture building, they can turn to contractual language to potentially minimize their FCA liability.

The PE firm can seek contractual legal protections from the portfolio company should the former face FCA liability because of the latter’s actions. For starters, any acquisition agreement should contain a representation or warranty regarding the portfolio company’s knowledge of pending FCA claims against it and any history of prior claims. In addition, acquisition agreements should contain clauses that indemnify and hold harmless the PE firm concerning any FCA claim lodged against it due to a portfolio company’s wrongdoing.

A PE firm also could require a portfolio company to purchase insurance that will pay for any FCA liability the former faces because of the latter’s misconduct, as well as all legal bills the former incurs when defending itself against allegations of FCA misconduct.

An ounce of prevention is worth a pound of legal liability

Employing these two strategies to potentially avoid liability under the FCA might not eliminate all of the challenges that cause PE firm leadership to worry about their portfolio companies' prospects. It will, however, mitigate a significant challenge that, unlike macro-economic conditions, is within the PE firm's capability to address.

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