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State AGs May Put Investors on the Hook for Co. Bad Acts

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Over the last few years, private equity firms and other investors have sought to take on a more active role in the management of the companies they purchase, hoping to ensure the success of the businesses in which they have acquired an interest.

But that new, active role comes with risk. State attorneys general and others are ready to test the limits of the law surrounding the corporate form, and recent enforcement activity and litigation suggests they could be successful.

Traditional Rules of Limited Liability

According to the 2003 U.S. Court of Appeals for the Ninth Circuit decision in *Dole Food Co. v. Patrickson*, "A basic tenet of American corporate law is that the corporation and its shareholders are distinct entities."[1]

Under this theory of corporate separateness, shareholders are not generally liable for the debts and wrongdoings of the corporation,[2] and this principle applies whether those shareholders are individuals or are themselves corporations.[3]

Not only is it perfectly legal to adopt the corporate form or another limited liability structure for the express purpose of limiting the liability of a company's owners,[4] but the creation and adoption of this doctrine of corporate separateness was famously touted by former Columbia University President Nicholas Murray Butler as the "greatest single discovery of modern times."[5]

It reduces the risks of entering the marketplace, limiting the monetary loss an investor may experience to the size of his investment.

Limited liability structures allow individuals to pool resources and achieve goals that would be unattainable by individuals acting on their own. Limited liability "makes possible huge economy in production and trading" and is "the only possible engine for carrying on international trade on a scale commensurate with modern needs and opportunities," Butler said.[6]

Nevertheless, there is an exception to the general rule of limited liability.

A plaintiff can overcome the presumption of corporate separateness and recover directly from the shareholders of a corporation or members of a limited liability company if that plaintiff can show that a parent company, individual shareholder or member is using the business to perpetrate fraud or commit wrongdoing and that such actions are the proximate cause of the plaintiff's injury.[7]

To make such showing is difficult — demonstrating that a parent, shareholder or member exercises a high degree of control over the business is not enough to justify piercing the corporate veil.[8]

The law instead requires a plaintiff to show some connection between their injury and an improper means of doing business.[9] This nexus requirement comports with the purpose and recognized value of the corporate form, as well as principles of proximate causation.

At some point, the actions of the shareholders are too attenuated from the plaintiff's harm: Shareholders may elect a corporation's board of directors, but that board then elects officers who in turn delegate much of the day-to-day responsibilities of the business to other employees.[10]

The law does not typically hold someone accountable unless it was sufficiently foreseeable that such actions might cause a specific harm.[11]

Testing the Limits

The limits of these foundational legal principles are now being put to the test. In 2018 and 2020, private equity funds settled cases with the U.S. Department of Justice for violations of the False Claims Act based on the conduct of their portfolio companies.[12]

Recent investigations and litigation indicate that state attorneys general are also willing to look beyond the first line of bad actors in an attempt to hold deep-pocketed actors liable for the conduct of other corporations. Investors may now need to look farther down the attenuation chain to properly assess their potential liability.

For example, in the fall of 2021, a private equity fund agreed to pay $25 million in a settlement with the Massachusetts attorney general based on its alleged oversight of one of its portfolio companies.

The U.S. District Court for the District of Massachusetts ruled in favor of the attorney general on motions to dismiss and summary judgment.[13]

The court held that the attorney general had viable claims for false presentment under the federal False Claims Act and state equivalent. The case relates to the private equity fund's acquisition of a mental health care company in 2012.[14]

Six years later, the Massachusetts attorney general intervened in *Martino-Fleming v. South Bay Mental Health Center* in the District of Massachusetts alleging that the mental health care company employed unlicensed, unqualified and improperly supervised staff members in clinics across the state, and impermissibly submitted fraudulent claims to MassHealth for mental health services provided by such individuals.[15]

With respect to the private equity fund, the state attorney general claimed that the investor knew or should have known that its portfolio company was not in compliance with MassHealth's licensure and supervision regulations.[16]

The attorney general alleged in support of its claim that the private equity fund:

- Performed substantial due diligence prior to purchase of the company;
- Oversaw the mental health care company's operations and provided the company with strategic guidance;
- Received reports regarding the company's finances; and
- Advised the company with respect to its efforts to recruit and retain clinicians, making it aware of particular staffing issues and hiring decisions.[17]

The complaint also alleged that three employees of the private equity fund sat on the board of another corporation, which in turn controlled the board of the mental health care company.[18]

The private equity fund sought dismissal of all claims against it, noting that the attorney general had not even attempted to show that the private equity fund could be held liable under a piercing the corporate veil theory.[19]

Instead, the attorney general sought to hold the private equity fund directly liable for its own distinct role in submissions of the false claims to MassHealth.

The attorney general's claims survived the motion to dismiss and subsequent motion for summary judgment. At summary judgment, the court acknowledged that mere knowledge of the submission of false claims is not enough for liability under the federal FCA and state equivalent.[20]

However, the court held that there was sufficient evidence in the record to conclude that the private equity fund both knew of the fraudulent submissions and had the power to fix the regulatory violations but failed to do so.[21]

Citing its own previous decision denying the private equity fund's motion to dismiss, the court stated:

If a person knowingly participates in a scheme that, if successful, would ultimately result in the submission of a false claim to the government, he has caused those claims to be submitted.[22]

This case marks a shift. For years, the law has shielded private equity funds from liability for the debts and wrongdoing of their portfolio companies so long as they have not used that company as an instrumentality.

The type of control courts have required to pierce the corporate veil has involved more than "mere majority of complete stock control, but such a domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own," according to Fletcher Cyclopedia Corporations.[23]

The Massachusetts federal district court, however, seemed willing to make room for direct liability claims against the private fund despite the attorney general's failure to allege a piercing the corporate veil theory and assert instrumentality-type control.

Other state attorney general-led actions suggest that investors should prepare to see an increase in these direct liability types of claims.

In February 2021, McKinsey paid more than $600 million to settle state attorney general investigations into its role in helping opioid manufacturers turbocharge their opioid sales.[24]

Complaints filed alongside the settlement in the 47 member states alleged violations of state consumer protection laws, asserting that McKinsey advised on how to maximize profits from manufacturers' opioid products, including:

- Targeting high-volume opioid prescribers;
- Using specific messaging to get physicians to prescribe more opioid products to more patients; and
- Circumventing pharmacy restrictions in order to deliver high-dosage prescriptions.[25]

Despite the fact that McKinsey did not itself sell opioids or own any portion of the opioid business, the complaints claimed that McKinsey's own actions advising the companies, with respect to aggressively promoting and selling more of the highly addictive opioids, constituted unfair trade practices and directly and proximately caused harm to consumers in the various states.[26]

Further lawsuits now consolidated into In re: McKinsey & Co., National Prescription Opiate Consultant Litigation in U.S. District Court for the Northern District of California allege not only violations of various state consumer protection laws, but also common law claims for negligence, fraud and misrepresentation, public nuisance, civil conspiracy and negligence per se.

The multidistrict litigation plaintiffs, a group of school districts, local governments, third-party payors and tribal communities, assert that McKinsey proximately caused their harm and that the company had some recognizable duty not to deceive, encourage or facilitate the over-marketing and over-prescribing of controlled substances.[27]

On Oct. 26, 2022, McKinsey announced that it had reached an agreement in principle with certain subdivision and school district plaintiffs.[28]

On Jan. 9, McKinsey filed a motion to dismiss the remaining plaintiffs' claims, asserting that the plaintiffs' claims for violation of the Racketeer Influenced and Corrupt Organizations Act, negligence, misrepresentation, nuisance, conspiracy and unjust enrichment each fail as a matter of law.[29]

The White Mountain Apache Tribe's RICO suit filed on Jan. 25 in the Northern District of California over McKinsey's alleged role in the tribe's opioid epidemic seeks to join the multidistrict litigation.

Takeaways

State attorneys general and others appear to be charting a course for more aggressive enforcement of state laws that reaches beyond the party most clearly and directly responsible for some given harm.

The Massachusetts court's opinions suggest that at least some courts are willing to play ball. And this shift comes at a time private equity firms and other investors have sought to take on a more active role in the management of the companies they purchase.

If the multidistrict litigation court is willing to find that McKinsey did in fact have an affirmative duty to protect all those potentially affected by opioid manufacturers' sales to support common law negligence-based claims at issue in that case, it would certainly be cause for alarm among consultants and involved investors alike.

To what extent can investors continue to rely on their traditional understanding of corporate separateness and limited liability to insulate themselves from liability? Similarly, to what extent can they rely on traditional notions of foreseeability and proximate cause to predict potential legal exposure?

Private equity funds and other investors should carefully consider their conduct with respect to their portfolio companies in this evolving legal landscape.

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[1] *Dole Food Co. v. Patrickson*, 538 U.S. 468 (2003).

[2] *De Witt Truck Brothers, Inc. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 683 (4th Cir. 1976).

[3] § 1:1. Limited liability and the doctrine of piercing the veil, Piercing the Corp. Veil § 1:1.

[4] Id.

[5] M. Wormser, Disregard of the Corporate Fiction and Allied Corporation Problems 2–3 (New York: Baker, Voorhis and Co. 1927) (quoting Columbia University President Nicholas Murray Butler).

[6] Id.

[7] 1 William Meade Fletcher, Fletcher Cyclopedia of the Law of Corporations § 43 (footnotes omitted).

[8] Id.

[9] Stephen M. Bainbridge, Corporate Law § 1.1(C) (3d ed. 2015).

[10] Id.

[11] *Palsgraf v. Long Island R. Co.*, 162 N.E. 99, 101 (N.Y. 1928).

[12] Press Release, U.S. Dep't of Just., Former Owners of Therakos, Inc. Pay $11.5 Million to Resolve False Claims Act Allegations of Promotion of Drug-Device System for Unapproved Uses to Pediatric Patients (Nov. 19, 2020), https://www.justice.gov/usao-edpa/pr/former-owners-therakos-inc-pay-115-million-resolve-false-claims-act-allegations; Press Release, U.S. Dep't of Just., EEG Testing and Private Investment Companies Pay $15.3 Million to Resolve Kickback and False Billing Allegations (July 21, 2021), https://www.justice.gov/opa/pr/eeg-testing-and-private-investment-companies-pay-153-million-resolve-kickback-and-false.

[13] Press Release, Off. of Att'y Gen. Maura Healey, Priv. Equity Firm & Former Mental Health Ctr. Execs. Pay $25 Million Over Alleged False Claims submitted for Unlicensed and Unsupervised Patient Care (Oct. 14, 2021), 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.

[14] See Amended Consolidated Complaint ¶¶ 24-26, *United States ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*, No. 15-CV-13065-PBS (D. Mass. Jan. 4, 2019).

[15] Press Release, supra n.12.

[16] Amended Consolidated Complaint ¶¶ 248-49.

[17] Id. at ¶¶ 33, 188, 197.

[18] Id. at ¶ 200.

[19] Motion to Dismiss at 7, Martino-Fleming, No. 15-CV-13065-PBS.

[20] *United States ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*, 540 F. Supp. 3d 103, 110-11, 116 n.5, 118 (D. Mass. 2021).

[21] Id. at 130.

[22] Id. (citing *United States ex rel. Martino-Fleming v. South Bay Mental Health Center, Inc.*, 334 F. Supp. 3d 394 (D. Mass. 2018)).

[23] See 1 Fletcher Cyclopedia of the Law of Corporation, § 43 (collecting cases).

[24] Michael Forsythe & Walt Bogdanich, McKinsey Settles for Nearly $600 Million Over Role in Opioid Crisis, N.Y. Times (Feb. 3, 2021), https://www.nytimes.com/2021/02/03/business/mckinsey-opioids-settlement.html.

[25] See, e.g., Massachusetts Compl., ¶ 15.

[26] Id.

[27] See, e.g., Master Complaint (Subdivision), In re: McKinsey & Co., Inc. Nat'l Prescription Opiate Consultant Litig., No. 21-md-02996-CRB (N.D. Cal. Dec. 6, 2021).

[28] See Joint Status Report, In re: McKinsey, No. 3:21-md-02996-CRB (N.D. Cal. Oct. 26, 2022).

[29] Mot. to Dismiss Master Complaints for Failure to State a Claim, In re: McKinsey, No. 3:21-md-02996-CRB (N.D. Cal. Jan. 9, 2023).

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