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Secondary Liability Risks for Private Funds—Recent Developments

*Posted by Ari Berman, Tom Hill, and Cassie Lentchner, Pillsbury Winthrop Shaw Pittman LLP,
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Editor's note: Ari Berman and Tom Hill are partners and Cassie Lentchner is senior counsel at Pillsbury Winthrop Shaw Pittman LLP. This post is based on a Pillsbury memorandum by Mr. Berman, Mr. Hill, Ms. Lentchner, and Stephen Amdur.

Takeaways

- Private funds continue to face heightened secondary liability risks arising from their portfolio investments.
- The DOJ's False Claims Act litigation against a private equity firm emphasizes the importance of pre-acquisition due diligence and robust compliance programs.

In an age of heightened litigation risk and a motivated Securities & Exchange Commission (SEC), private funds need to be increasingly mindful of secondary liability risks, especially when evaluating costs and benefits of potential portfolio company ownership structures. Given the uncertainties, firms must take steps to mitigate such risks—including documenting oversight, observing corporate formalities, ensuring the creation and implementation of strong internal controls, and adequately training professionals who serve as directors.

As described in an earlier publication, government regulators have made clear their intent to focus on private funds. The developments we discuss below emphasize potential secondary liability risks that may draw firms into governmental crosshairs. Most recently, on September 18, 2019, the Department of Justice (DOJ) announced the settlement of a False Claims Act (FCA) case which named a private equity firm as a defendant. The settlement also prompts us to take a trip down memory lane to remind funds of the latest chapter in the *Sun Capital* pension fund litigation—namely, a November 2018 decision by the Massachusetts District Court reaffirming that two private equity funds bore responsibility for unfunded pension liabilities of a bankrupt portfolio company. These developments further highlight the expanding range of legal and regulatory risks facing private funds associated with making and managing their portfolio company investments.

Recent DOJ Settlement Signals Enhanced FCA Scrutiny for Private Equity Funds

Private equity firms should be aware of increasing FCA scrutiny in the health care industry and other industries where business with the government is a regular occurrence. On September 18, 2019, the Department of Justice announced that a compounding pharmacy, two of its executives, and a private equity firm had agreed to settle a FCA lawsuit for $21.36 million, resolving claims that they allegedly violated the FCA through their involvement in a kickback scheme to generate referrals of prescriptions for creams and vitamins, which were reimbursed by a federal health care program. In 2018, the DOJ filed a complaint-in-intervention[1] in the Southern District of Florida, naming as defendants not only the compounding pharmacy involved and its executives, but also the private equity firm, Riordan, Lewis & Haden Inc. (RLH), which had a significant ownership state in the pharmacy. RLH was described as having been actively involved in the management of the company, including day-to-day management of the business operations of the pharmacy. The DOJ's allegations set forth in detail the basis for liability for RLH as a private equity owner of the pharmacy, focusing on RLH's overall control of the pharmacy, including its board of directors, as well as the fact that two of RLH's partners, who served as officers of the pharmacy company, personally were involved in leading the pain management initiative from which the alleged kickbacks arose. In sum, according to the DOJ, RLH allegedly knew of an agreed plan to pay outside marketers to generate the prescriptions and financed the kickback payments to the marketers.[2]

While it is uncommon for the DOJ to name the private equity firm itself as a defendant, and RLH's activities were particularly intertwined with those of its portfolio company, the case is a useful reminder for private equity firms to conduct thorough due diligence and exercise caution when managing investments in healthcare and other government-facing industries (the DOJ's complaint specifically alleged that RLH knew when it acquired the pharmacy that health care providers that do business with federal programs are subject to laws and regulations designed to prevent fraud). It serves as a reminder of potential liability for private funds under various federal and state statutes for violations committed by their portfolio company investments; it also underscores the importance of board designees playing an active role to ensure compliance with applicable laws.

Furthermore, unlike typical regulatory cases, False Claims Act litigations are almost always initiated as *qui tam* actions by whistleblower relators and their private counsel. With DOJ expanding the reach of defendants to include private equity, at least under certain fact patterns, we can expect the private FCA relator bar will pick up on this expansion and more regularly include private fund defendants in their *qui tam* complaints. Even if DOJ then declines to intervene in the action, as is the case in the majority of *qui tam* complaints, private equity defendants will still have to contend with defending themselves in these non-intervened cases being pursued by private relators' counsel.

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[1] *United States ex rel. Medrano v. Diabetic Care RX, LLC,* No 15 Civ. 62617 (S.D. Fla.).

[2] The District Court initially granted defendants' motion to dismiss the DOJ's complaint with leave to amend, which the DOJ did in March 2019. The parties settled the litigation prior to a ruling on defendants' motion to dismiss the amended complaint.

Latest Chapter of *Sun Capital*—Pension Liability Risk for Private Equity Continues

The Sun Capital pension fund litigation saga has been the subject of numerous analyses. It is nonetheless important to focus briefly on its latest chapter—namely, the Massachusetts District Court's November 2018 reaffirmance of its 2016 ruling that two private equity funds were responsible for unfunded pension liabilities of a bankrupt portfolio company. In short, the *Sun Capital* case concerned whether a private equity fund may be subject to a portfolio company's multiemployer pension withdrawal liability under the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA). The litigation has ping-ponged between the District Court and First Circuit over the question of whether two Sun Capital funds were actively engaged as a trade or business in a bankrupt portfolio company which owed millions in withdrawal liability to the pension fund. The courts have focused on whether the private equity fund and portfolio company were part of the same "controlled group" such that the fund and portfolio company may have joint and several liability for unfunded single-employer pension liabilities and multiemployer plan withdrawal liability. Ultimately, the courts determined that Sun Capital could be liable for the pension obligations of its bankrupt portfolio company because Sun Capital was sufficiently involved in the operation of the portfolio company for its activities to be characterized as being involved in a "trade or business." The First Circuit noted that the funds' limited partnership agreements and private placement memoranda stated that the funds were actively involved in the portfolio companies' management and the general partner had the authority to make decisions about hiring, firing and compensation of agents and employees of the portfolio companies. The funds also had the right to place two of their employees on the portfolio company's board, which provided effective control of the board.

In November 2018, the Massachusetts District Court reconsidered and reaffirmed its previous ruling on the merits that two private equity funds were engaged in a trade or business and were under common control—thereby making them responsible under the MPPAA for a bankrupt portfolio company's withdrawal liability to a multiemployer pension plan.[3] This latest *Sun Capital* chapter serves as a reminder to private funds of the importance of evaluating investments in companies with pension liabilities, especially focusing on the nature of management activities private funds undertake with respect to their portfolio companies.

Practical Advice for Investment Firms and Their Personnel

As investment firms know, there is a fine line between "substantial assistance" to a portfolio company and ordinary management of investments to maximize value for private fund investors (e.g., having designees on the board of directors, receiving regular reports regarding the business, providing certain services to portfolio companies). Beyond serving as a cautionary tale, these cases emphasize the importance of conducting thorough pre-acquisition due diligence and considering the risk profile of potential investments (including the risk that a portfolio company's business model would get the attention of regulators).

[3] *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, No. 10-10921-DPW, 2018 WL 6169366 (D. Mass. Nov. 26, 2018).

Although there is no way for an investment firm to fully insulate itself from secondary liability, investment firms should consider the following actions to minimize their risks:

A. **Instill Robust Compliance Programs and Adequate Controls.** Confirm that portfolio companies design and implement strong compliance programs and internal controls, including those that confirm the accuracy of portfolio companies' public disclosures. The SEC and DOJ have delivered a clear message that they expect to see comprehensive and effective compliance programs and the lack of such programs will result in penalties. The September 2016 SEC and DOJ settlement with Och-Ziff Capital Management (Och-Ziff) demonstrates the importance of compliance policies and procedures that are sufficiently robust to prevent violations of the Foreign Corrupt Practices Act (FCPA)—both in terms of procuring investors and when making private equity investments. More recently, DOJ reiterated and expanded on this guidance, releasing "Evaluation of Corporate Compliance Programs." This guidance document for its prosecutors makes clear that the adequacy and effectiveness of a corporation's compliance program are key considerations when determining DOJ's course of action regarding any wrongdoing at the company. It is critically important that portfolio companies follow best practices and that designated board members are adequately trained to discharge their oversight duties over the compliance functions of portfolio companies, to evaluate the adequacy of the program in the face of such risks, and to recognize red flags that may arise.
B. **Conduct Thorough Pre-Acquisition Diligence.** Investment firms should conduct thorough pre-acquisition diligence to identify and address any potential violations. Compliance issues and relevant compliance risks, including activities in high-risk industries or areas, should be seriously explored during due diligence. Through careful assessment of the risks presented, a firm can ensure the adequacies of the compliance controls that will be required to address the risks.
C. **Consider Structuring Alternatives.** Consider opportunities for structured investments, such as preferred stakes, in which existing investors retain substantial equity interests. (If it is not practical for business reasons to own less than a majority stake, then investment firms should be even more mindful to take into consideration the other pointers in this list.)
D. **Include Independent Directors at the Portfolio Company Level.** By including the election of independent directors at the portfolio company level, investment firms can enhance the boundary between themselves and their portfolio companies.
E. **Participate in the Hiring of Qualified Advisers.** Take steps to make sure that portfolio companies engage qualified advisers to aid in disclosures and overall legal and regulatory compliance. Separate legal and financial advisors to act in the interests of the applicable portfolio companies—as opposed to their shareholders—may be appropriate in certain circumstances.
F. **Document "Good-Faith" Efforts.** Investment firms can raise an affirmative defense of good faith in response to a claim for control person liability in the federal securities law context. Be sure to document such efforts, including demonstrating that: (1) the investment firm exercised care in its supervision of portfolio company activities, and (2) the investment firm maintained and enforced a reasonable system of supervision and controls.
G. **Respect Corporate Formalities.** Examples include maintenance of separate finances, capitalization, and books and records of portfolio companies, as well as separate organizational documents, and consistent documentation of minutes of board meetings. Consider other methods of drawing clear lines in corporate policies and agreements to

ensure that your board designees maintain appropriate separateness between their roles as directors of portfolio companies and investment firm employees.

H. **Purchase Effective Directors and Officers Insurance.** Verify that the portfolio company has an adequate policy to provide the first layer of protection for claims brought against board designees of the investment firm. Investment firms should also verify that their own insurance is both adequate in amount and scope of coverage.

Conclusion

These recent developments underscore the importance of private funds considering the level of their involvement in shaping operational decisions at the portfolio company level. As demonstrated in each of these cases, the higher the degree of involvement in day-to-day operations, the greater the risk the private fund may be named as a defendant. These cases are part of a growing trend by litigants to pursue theories of private fund liability for portfolio company conduct. Private funds thus face a difficult balancing act of appropriately managing portfolio company investments for their limited partners while being careful not to expose themselves to greater litigation and regulatory risk. As the risks multiply, including with respect to common law veil-piercing, securities law control person liability and overall SEC focus on private funds, investment firms cannot focus only on their own legal compliance but must remain diligent with respect to the portfolio companies in which they invest.