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Private Equity Portfolio Risks – Investigating FCA, FCPA, and Other Federal Claims Involving Portfolio Companies


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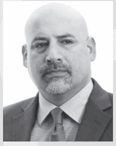
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Introduction

Globally, private equity ("PE") generated $512 billion in buyout deal value during the first half of 2022, putting it on pace to produce the second-highest annual total ever (behind 2021's all-time record). The 18-month total of $1.7 trillion is by far the strongest year-and-a-half in the industry's history.

In particular, in 2021, PE invested approximately $151 billion of capital into healthcare globally, more than double the year prior. However, as we near the end of 2022, PE activity is slowing down. Uncertainty around inflation and rising interest rates are causing buyers and sellers to have trouble aligning on prices, leading to a slowdown in PE deals. This, coupled with a potential looming recession, may lead to turbulent times in the short term for PE firms. As such, it will be particularly important for PE firms to maintain an active role in the management of their portfolio companies to both ensure financial stability through a potential recession and to "future-proof" the business by focusing on key initiatives.

In addition to the above, the Department of Justice ("DOJ") and the U.S. Securities and Exchange Commission ("SEC") have made it clear that they are increasing scrutiny on enforcing regulatory actions, such as violations of the False Claims Act ("FCA") and Foreign Corrupt Practices Act ("FCPA"), against PE firms based on their portfolio companies' misconduct. Given this, it is important that PE firms implement measures to protect themselves and their investments. In addition to their general due diligence measures, firms should employ a compliance "hygiene assessment" for prospective investments to ensure compliance and evaluate risk. In addition, following their investment, firms should implement robust compliance measures, particularly in highly regulated industries such as healthcare, to effectively monitor compliance issues. Finally, PE firms should be well equipped to both investigate and remediate any misconduct that may arise.

Types of Risk

FCA

The FCA is a civil statute that imposes liability on any person or company that knowingly or recklessly submits, or causes the submission of, materially false claims for payment, or makes false statements material to a false claim. See 31 U.S.C. § 3729(a)(1). Claims for payment can be made directly to the federal government or its agents, or to entities that receive federal funds, such as states.

While FCA cases may be brought by the government directly, they are more often brought by private individual whistleblowers known as "relators" on behalf of the government. These *qui tam* cases are brought on behalf of the government in exchange for a piece of the government's recovery. Notably, *qui tam* cases are filed under seal to allow the DOJ time to investigate the underlying allegations. As such, a defendant may be unaware of a *qui tam* suit brought against them for years. Following their investigation, the government may decide to intervene and take over the suit or allow the relator to litigate. Once the DOJ makes this election, the case is unsealed and the complaint is served on the defendant, with the litigation proceeding as any other.

Importantly, defendants found to have violated the FCA may be liable for triple the government's actual damages plus monetary penalties linked to inflation for each claim. Indeed, the FCA is a powerful tool for the federal government to obtain large recoveries. In the fiscal year 2021 alone, the DOJ recovered more than $5.6 billion in settlements and judgments in FCA cases.

As such, FCA cases have the potential to impose high costs on defendants. Analyses indicate that over 75% of FCA cases where the government either brings suit or intervenes result in a judgment or settlement. These judgments or settlements, depending on the conduct at issue, can range anywhere between several hundred thousand dollars to several hundred million or even billions of dollars. Furthermore, in some instances, a defendant may be barred from conducting business with the government in the future. Nevertheless, even if a defendant prevails in a government-brought *qui tam* suit, they still will likely have been subject to years of extremely costly litigation.

FCPA

The FCPA, enacted in 1977, generally prohibits the payment of bribes to foreign officials to assist in obtaining or retaining business. In addition, the FCPA contains accounting requirements mandating companies to maintain accurate books and have an internal system to ensure finances are maintained openly and in accordance with FCPA principles.

The FCPA applies to both United States "issuers" and "domestic concerns". An "issuer" is any company who has securities registered in the U.S. or is required to make periodic reports to the SEC. A "domestic concern" includes any individual who is a citizen or resident of the U.S. as well as any company incorporated or with its principal place of business in the U.S. Indeed, the FCPA extends to these companies as well as their officers, directors, employees, stockholders, and agents — which can include but is not limited to third-party agents, consultants, distributors, and joint-venture partners. Importantly, the FCPA can be applied to prohibited conduct anywhere in the world, not just on U.S. soil. The FCPA specifically prohibits any person or organisation in the above categories from providing "a payment, offer, authorisation, or promise to pay money or anything of value" to a "foreign government official (including a party official or manager of a state-owned concern), or to any other person, knowing that the payment or promise will be passed on to a foreign official". 15 U.S.C. §§78dd-1(a).

These definitions are broad enough to allow the government to impose FCPA violations for nearly any benefit given to a person or entity for the purpose of impacting business dealings with a foreign government. This can include non-monetary benefits such as entertainment and travel. Further, there is no lower limit to the benefit, meaning that even extremely small bribes are actionable under the FCPA. Moreover, the FCPA covers an *offer* of payment, meaning a payment or benefit need not actually be given or received to be prohibited.

Also important in the FCPA analysis is that any payment or offer must be made with a "corrupt" motive, which is described as an "evil motive or purpose, an intent to wrongfully influence the recipient". Therefore, an FCPA violation must include a conscious intent to wrongfully influence the recipient of any benefit given.

Companies or individuals that violate the FCPA may be subject to significant penalties. Notably, the SEC may bring civil enforcement actions against issuers and, if found to have committed a violation, those issuers may have to disgorge any gains received as a result of payments made in violation of the FCPA. In addition, companies that have committed FCPA violations may be subject to a prejudgment interest and substantial civil penalties.

Specifically, corporations and other businesses who violate the FCPA may be fined up to $2 million for each violation. In addition, violators may also be subject to oversight by an independent consultant known as a monitor.

Risk Mitigation

As noted above, violations of both the FCA and FCPA can result in significant monetary penalties for companies and their stakeholders. Notably, PE firms who experience a violation of one of these statutes at their portfolio companies may themselves be subject to these penalties. In particular, the DOJ has in recent years highlighted efforts to investigate PE firms that invest in companies receiving government funds for violations of the FCA. In addition, the FCPA already has a broad reach in terms of the asserting liability against investors of companies that violate the Act. As such, to mitigate risk, it is imperative that PE firms (1) conduct rigorous pre-investment due diligence in the form of a compliance "hygiene assessment", and (2) work to establish post-investment controls and monitoring.

FCA

While spurred by the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, the DOJ's initiative also extended to PE firms that invest in highly regulated spaces, including healthcare and life sciences. Specifically, the DOJ pointed out that any PE firms investing in those spaces should be aware of the laws and regulations and warned that firms may be subject to FCA liability if they take an active role in illegal conduct at one of their portfolio companies. Even more recently, the DOJ has indicated that FCA liability may befall PE firms who learn about violations during due diligence and fail to remedy the issues after closing.

For example, in July 2021, Alliance, an electroencephalography ("EEG") testing company, agreed to pay $13.5 million to settle claims that the company purportedly paid kickbacks to referring physicians. In addition, Ancor Holdings LP, a private investment company who invested in Alliance, agreed to pay $1.8 million for causing false billings through its management agreement with the company. Ancor purportedly learned of the kickbacks based on due diligence performed prior to investing in Alliance and did not fix the issues following the close of their investment.

Pre-investment due diligence

To best mitigate risk, PE firms should conduct thorough due diligence around both the investment target and the target company's sector. Particular care should be taken involving companies who operate in highly regulated spaces, such as healthcare or life sciences. In addition to traditional due diligence measures, PE firms must conduct a compliance "hygiene assessment" that analyses a company's history with compliance and potential compliance risk areas.

Primarily, this assessment should look for any past compliance issues or enforcement, both specific to the sector and generally. This piece is particularly important given Deputy Attorney General ("DAG") Lisa Monaco's September 15, 2022 comments regarding policies on corporate criminal enforcement. Specifically, DAG Monaco rolled out new DOJ policies that aim to mix incentives and deterrence to make a business case for responsible corporate behavior. In addition, she laid out considerations for the resolution of criminal and civil regulatory violations. Of particular importance in this context is DAG Monaco's comments regarding a company's history of misconduct. She dictated that, when determining an appropriate resolution for a regulatory violation, the DOJ should consider a company's full criminal, civil, and regulatory record. As such, she stated that companies who have a recent history of misconduct will be looked at unfavourably when determining a resolution of discovered misconduct.

Given these comments, it is important that PE firms have a deep understanding of the history of their portfolio companies' civil, criminal, and regulatory record. In the event that a violation does come to light down the line, the DOJ will use this record as a metric in calculating a potential resolution. As such, PE firms should be aware that prior misconduct of their target companies may impact future resolutions with the DOJ if misconduct rises again.

Post-investment compliance

As stated above, PE firms that fail to correct compliance issues discovered in due diligence may be at risk. Nevertheless, whether or not a company has a history of misconduct, it is prudent for PE firms to evaluate an investment company's ongoing compliance hygiene and seek to create and maintain a robust and effective compliance programme. First and foremost, PE firms should work to regularly evaluate compliance-based policies and procedures to ensure they are effective and being properly communicated and implemented. Additionally, depending on its size, a company should have a dedicated compliance officer, committee, or department that oversees this exercise. Further, employees should be trained on the various policies and procedures as well as various ways to report potential misconduct.

Another measure PE firms could take can be gleaned from DAG Monaco's September 15, 2022 remarks. Specifically, she remarked that the DOJ supports compensation systems that impose financial penalties for misconduct. These penalties both deter risky behaviour and foster a culture of compliance. Additionally, companies may also add financial incentives that reward compliance-promoting behaviour.

However, it is not sufficient to simply implement a compliance programme. PE firms should remain vigilant in maintaining a company-wide culture of compliance. Even if PE firms do not have direct management roles at their portfolio companies, they should still work together with management in their capacity as owners to help foster this culture. Indeed, a true culture of compliance is only possible with an effective "tone at the top", meaning that owners, managers, and directors must be aligned in their goal to create and maintain a true culture of compliance.

FCPA

Pre-investment due diligence

In the FCPA context, a compliance "hygiene assessment" should involve analysing an investment target's FCPA risk profile. This includes whether a target does business in countries with a high FCPA risk, such as China, India, Venezuela, and countries in the Middle East or in sectors that pose a particular FCPA risk, such as energy, defence, or telecommunications.

In addition, PE firms should determine if a target company has significant foreign government contacts or customers, or if the company regularly relies on brokers, agents, or other third parties. If a sufficient number of these considerations point to an FCPA risk, a PE firm should consider preparing a full FCPA due diligence plan.

A robust and effective due diligence inquiry should not only focus on the target company's financials but should also include a comprehensive overview of the company's customers, relationships with third parties, foreign government contacts, ownership structure, compliance controls, and history of similar violations.

Post-investment compliance

Whether or not a target company presented an FCPA risk in due diligence, it is good practice for PE firms to continue to ensure that their portfolio companies maintain proper FCPA compliance. In particular, this includes ensuring the target company has a robust FCPA and anti-corruption policy and that employees receive training. Further, any companies that use foreign agents should consider requiring any brokers or third parties to proceed under contracts containing anti-corruption language. Finally, companies should have in place audit procedures to periodically monitor transactions and other conduct to analyse any potential FCPA violations.

Managing Investigations

Even if a company follows the above directions, regulatory violations may still occur. In that case, companies should be aware of how best to investigate and remediate these potential issues.

Internal management

As a PE firm, it is important to be involved in overseeing an investigation into alleged misconduct at a portfolio company. If the portfolio company has, pursuant to the principles above, put into place a proper compliance programme, it is likely that the company will learn of potential misconduct before a government entity. Assuming that is the case, the following are prudent next steps.

Internal investigation considerations

The first step of an investigation is to define the purpose and scope. This includes identifying the goals of the investigation, including potential legal and related implications, as well as the relevant time periods, business units and employees, and subject matters to focus on. For PE firms, this will likely require obtaining the buy in from management, directors, and potentially other stakeholders.

Another consideration that will need to be addressed quickly is whether the investigation should be conducted under privilege. If legal advice is needed regarding the investigation or its findings, or if litigation or regulatory investigations are anticipated, steps should be taken to establish and protect the attorney-client privilege and attorney work product.

Next, if the decision is made to conduct the investigation under privilege, a PE firm will need to determine whether to conduct the investigation in-house or to bring in outside counsel. This decision is driven by several factors, including: whether the greater resources available to outside counsel are needed to handle the investigation quickly and efficiently; whether the experience of outside counsel with, for example, a particular government agency, or the ability to benchmark industry behaviors, is needed; whether the experience of outside counsel with investigations would be useful in making complex judgment calls; and whether the relative independence of outside counsel would be an advantage, particularly as remediation steps following the investigation are considered and implemented.

Following this, the bulk of the investigation will consist of fact finding. Fact finding comprises two main components: document and data review; and witness interviews. For both of these, it is important to keep clear the scope and purpose of the investigation to find relevant facts efficiently and avoid unnecessary costs.

Once fact finding has been completed, the investigation findings should be reported to the company. These findings may include not only a summary of the relevant facts, but also conclusions such as:

a. the company and/or individuals violated the law, rules or regulations;
b. the company and/or individuals violated company policy or procedure;
c. there was a root cause of any determined non-compliance;
d. any potential non-compliance could have been prevented;
e. any potential non-compliance has been remediated and/or whether corrective measures have been put in place to prevent similar future non-compliance;
f. the tone set at the company was sufficiently supportive of ethical conduct by employees (a good "tone at the top"); and
g. there was any attempt to retaliate or actual retaliation against a whistleblower.

Remedial measures

If an investigation uncovers misconduct, companies will need to ensure that it is halted immediately and that corrective actions are taken to ensure the misconduct does not happen again.

These remedial measures can include a change in personnel, disciplinary actions, additional employee training sessions, a change in policies and procedures, and a change in monitoring practices. Ultimately, PE firms and their counsel will want to ensure that any remediation is both business-minded and effective to remedy prior and prevent future misconduct.

Government interaction

Importantly, during the course of an internal investigation as outlined above, companies should always be cognisant of potential disclosure to relevant government authorities.

Indeed, the most recent guidance put forth by the DOJ in terms of best practices for interfacing with government investigators is DAG Monaco's September 15, 2022 comments. As stated above, some of DAG Monaco's remarks discussed measures that companies should put into place prior to any misconduct to receive the best possible incentives from regulators — including fostering a culture of compliance through appropriate compensation systems and fully remediating prior misconduct.

However, DAG Monaco's comments also cover best practices for companies currently under investigation by regulators. For example, she explains that companies under investigation can receive credit for cooperating with the DOJ, resulting in reduced penalties, deferred prosecution, or non-prosecution agreements. The new DOJ policies, however, state that companies that elect to delay the disclosure of critical documents or information while they consider how to mitigate the damage or investigate on their own will receive reduced corporate credit, or no credit at all. The DOJ wants cooperating companies to notify prosecutors of hot documents or evidence on first reaction. Companies should prioritise disclosure of evidence that is most relevant for assessing individual culpability.

Additionally, DAG Monaco advised that voluntary self-disclosure is the clearest path to avoid a guilty plea or indictment. The DOJ expects good companies to "step up and own up" to misconduct, and believes voluntary self-disclosure is an indicator of a working compliance programme and healthy corporate culture. Companies that appropriately "own up" will be rewarded. Because self-disclosure programmes have been successful in the past, every DOJ component will now have a programme that incentivises voluntary self-disclosure. If a component lacks a formal documented policy, it should draft one. The policies will provide clear expectations of what self-disclosure entails and identify the benefits that a self-disclosing company can expect.

There will also be common principles that apply across voluntary self-disclosure policies. For instance, the DOJ will not seek a guilty plea when a company has voluntarily self-reported, cooperated, and remediated misconduct. The DOJ will also not require an independent compliance monitor for such a corporation if, at the time of resolution, it has also implemented an effective compliance programme.

Conclusion

Overall, given the government's focus on holding PE firms accountable for their portfolio companies' violations of regulations such as the FCA and FCPA, firms should dedicate resources to ensuring that they are not on the wrong end of a judgment or settlement. First, they must understand the risk profile of target companies by conducting robust pre-investment due diligence. This requires an understanding of the space the target company operates in and the potential regulatory pitfalls they might encounter. Further, PE firms should work with their portfolio companies to ensure the implementation and maintenance of both an effective compliance programme and overall culture of compliance. Finally, if issues arise, PE firms should be equipped to both investigate potential wrongdoing and effectively interface with government officials to limit liability.

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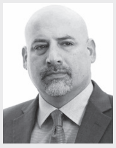

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