Doing your diligence: Monitoring of portfolio companies

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WHO SHOULD READ THIS?

Acquirers, including private equity and venture capital firms, that own portfolio companies or are pursuing targets in regulated industries.

WHY READ THIS?

Federal regulators have recently taken enforcement action against investment firms related to misconduct at the entities in which they invested.

Firms that acquire an interest in a regulated entity can mitigate the risk of enforcement by monitoring the actions of those entities, as well as their involvement in such entities.

Federal regulators have historically shied away from pursuing claims against private equity and venture capital firms for the activities of portfolio companies, but enforcement actions brought by the Consumer Financial Protection Bureau and the Department of Justice within the last year signal a potential change in approach. The actions make clear that due diligence should not be considered (or relied upon as) a one-time, transactional effort, but as an ongoing discipline through which private equity firms monitor the operations of portfolio companies in highly regulated industries such as health care or consumer finance. Private equity firms should therefore consider periodic evaluations of their portfolio companies — including an assessment of their own involvement in the activities of these companies — to supplement acquisition-related due diligence.

RECENT ENFORCEMENT ACTIONS AGAINST PRIVATE EQUITY FIRMS

CFPB v. Aequitas Capital Management, Inc. In August of 2017, the CFPB resolved charges against a private equity firm for violations of the Dodd-Frank Act's prohibition of abusive acts and practices related to student loans the firm funded or purchased.[1] Specifically, the firm invested in a high-cost loan program that a college had created to satisfy the 90/10 rule under Title IV of the Higher Education Act of 1965.[2] Under the 90/10 rule, for-profit colleges are not eligible to receive proceeds of federal student-aid loans if those types of loans represent more than 90 percent of their revenues.[3]

The CFPB alleged that the college increased tuition beyond the amount that Title IV loans would cover, forcing students to obtain additional private loans that could account for at least 10 percent of the college's revenues.[4] A rule in 2012 prohibited colleges from funding additional private loans, so the college arranged to have the private equity firm purchase and fund loans obtained by the college's students.[5] However, as part of the arrangement, the college agreed to

1. Press Release, CFPB, CFPB Takes Action Against Aequitas Capital Management for Aiding Corinthian Colleges' Predatory Lending Scheme (Aug. 17, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-aequitas-capital-management-aiding-corinthian-colleges-predatory-lending-scheme/.
2. *Id*.
3. *Id*.; 20 U.S.C. § 1094(a)(24).
4. Complaint at 3, *CFPB v. Aequitas Capital Management Inc. et al.*, No. 17-cv-1278 (D. Or. Aug. 17, 2017), ECF No. 1 ("Aequitas Complaint").
5. *Id*.

repurchase all loans that became delinquent more than 90 days.[6] The CFPB found that the private loans were predatory, and that the private equity firm's support and funding was abusive due to resulting harm to students. The enforcement action targeted the college as well as the participating private equity firm.

Significantly, the CFPB said the private equity firm had "failed to perform any meaningful due diligence concerning the college's marketing and representations to its students" about the loan program, and that it "took at face value" the college's assertions that lawsuits related to the loans "were without merit or easily disposed of."[7] The CFPB's final order required the firm to, among other things, forgive some loans extended to the college's students and reduce all other such loans by more than half.[8] The CFPB estimated that these measures would amount to more than $183 million in loan forgiveness and reduction for approximately 41,000 students.[9]

United States ex rel. Medrano v. Diabetic Care Rx. The DOJ in February 2018 filed a complaint against a Florida compounding pharmacy and one of its investors, a private equity firm, for violations of the False Claims Act.[10] The DOJ alleged that the firm and the pharmacy paid kickbacks to marketers for prescription referrals that would be reimbursed by TRICARE — a federally funded health care program for military personnel and their families.[11]

The government named the private equity firm as a defendant because it determined that the firm and two of its partners — who also served as officers and directors of the pharmacy and a holding company with an ownership interest in the pharmacy — participated in the alleged misconduct.[12] In particular, the DOJ highlighted the private equity firm's:

- **Involvement in strategic decisions.** The complaint alleged that the private equity firm "initiated" the pharmacy's entry into the business of non-sterile compounding of topical creams" for pain-management because it said the creams were extraordinarily profitable and would result in a "'quick and dramatic payback'" on its investment.[13] The private equity firm also allegedly requested to be involved in "important decisions starting at an early stage in the consideration process."[14]
- **Involvement in hiring and compensation.** The complaint alleged that one of the private equity firm's partners recommended the hiring of a CEO despite a consultant's advice that the individual would "require more careful management than [the private equity firm] may wish to provide."[15] Once the individual was hired, the partner suggested compensating the CEO with stock options that would be worth millions of dollars if the pharmacy's value reached a certain benchmark by the time the private equity firm sold the pharmacy.[16]

6. *Id*.
7. *Id*. at 24.
8. Stipulated Final Judgment and Order at 3, *CFPB v. Aequitas Capital Management Inc. et al.*, No. 17-cv-1278 (Sept. 1, 2017), ECF No. 8.
9. Press Release, CFPB, CFPB Takes Action Against Aequitas Capital Management for Aiding Corinthian Colleges' Predatory Lending Scheme (Aug. 17, 2017), https://www.consumerfinance.gov/about-us/newsroom/cfpb-takes-action-against-aequitas-capital-management-aiding-corinthian-colleges-predatory-lending-scheme/.
10. Complaint, *United States ex rel. Medrano v. Diabetic Care Rx, LLC d/b/a Patient Care America et al.*, No. 15-cv-62617, (S.D. Fla. Feb. 16, 2018), ECF No. 36 ("PCA Complaint"); See Press Release, U.S. Dep't of Justice, United States Files False Claims Act Complaint Against Compounding Pharmacy, Private Equity Firm, and Two Pharmacy Executives Alleging Payment of Kickbacks (Feb. 23, 2018), https://www.justice.gov/opa/pr/united-states-files-false-claims-act-complaint-against-compounding-pharmacy-private-equity.
11. *Id*. at 1.
12. *Id*. at 3.
13. *Id*. at 10.
14. *Id*. at 12.
15. *Id*. at 11.
16. *Id*. at 12. The complaint also alleged that the private equity firm partner supervised the CEO, and specifically directed the CEO to consult with the firm partners before entering into contracts that obligated the company to make annual payments over $50,000, or total payments exceeding $150,000. *Id*.

- **Knowledge of finances.** Board members, including certain of the private equity firm's partners, received the compounding pharmacy's financial statements, which reflected that commission payments had been made to marketers.[17]
- **Payment of commissions.** The private equity firm stepped in to pay commissions to marketers before the pharmacy received reimbursement from TRICARE.[18]

Further, the complaint maintained that the private equity firm, as an investor in health care companies, "knew or should have known … that health care providers that bill federal health care programs are subject to laws and regulations designed to prevent fraud, including [the Anti-Kickback Statute]."[19]

Although the case is ongoing, the complaint suggests that activities commonly undertaken by private equity firms may come under greater scrutiny by enforcement authorities. In addition, it serves as a timely reminder that regulators expect private equity firms to know and obey the laws in any industry in which they choose to invest — particularly in those that are highly regulated.

LITIGATION AND GUIDANCE THAT COULD PROVIDE A FOUNDATION FOR FUTURE ENFORCEMENT ACTION

Private litigation. Litigation against private equity firms for misconduct by the companies in which they invest is not without precedent. A Massachusetts district court in 2016 held that private equity funds managed by Sun Capital were jointly and severally liable for $4.5 million in pension withdrawal liability incurred by a bankrupt portfolio company owned by these funds.[20] In reaching this conclusion, the court relied, in part,[21] on the fact that the private equity fund was actively involved in the management of the portfolio company, noting that the economic benefit that inured to the fund exceeded the benefits available to ordinary passive investors.[22] The analysis employed in this type of private litigation may serve as an example to state and federal regulators evaluating whether private equity firms are responsible for misconduct of the companies in which they invest.

REGULATORS EXPECT PRIVATE EQUITY FIRMS TO KNOW AND OBEY THE LAWS IN ANY INDUSTRY IN WHICH THEY CHOOSE TO INVEST — PARTICULARLY IN THOSE THAT ARE HIGHLY REGULATED

CFPB and OCC guidance. The posture of the CFPB and the Office of the Comptroller of the Currency on vendor management by supervised financial institutions may provide further insight into how regulators perceive the relationship between private equity firms and their portfolio companies. Both agencies in recent years have pursued enforcement actions against institutions for the actions of their third-party vendors, and have clearly articulated that they view the institutions as fully responsible for the actions of their vendors.[23] Both the CFPB and the OCC expect

17. *Id*. at 19.
18. *Id*. at 19.
19. *Id*. at 28.
20. *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, 172 F. Supp. 3d 447, 467 (D. Mass. 2016).
21. We note that in Multiemployer Pension Plan Amendments Act ("MPAA") cases, like this one, the court employs a two-part test for determining an investor's liability. *Id*. at 452. Indeed, relying on various factors, the court determines whether the investor organization is (1) is under common control with the obligated organization; and (2) a trade or business. If these two conditions are satisfied, the court may impose withdrawal liability on the investor. *Id*.
22. *Id*. at 448.
23. *See, e.g.*, Consent Order, Capital One Bank (U.S.A.) N.A., CFPB No. 2012-CFPB-0001 (July 16, 2012), Doc. No. 1, http://files.consumerfinance.gov/f/201207_cfpb_consent_order_0001.pdf (ordering Capital One Bank to refund customers and pay a $25 million penalty for deceptive marketing tactics used by Capital One's vendors); Consent Order, Capital One Bank (USA), N.A., OCC No. AA-EC-2012-62 (July 17, 2012), Doc. No. 2012-152 (finding that Capital One Bank failed to maintain effective risk management and control processes in connection with the market and sale of certain products by the bank's vendors).

supervised banks and nonbanks to implement a process for managing the risk of service-provider relationships at the outset of the relationship and going forward.[24] Key aspects include spelling out compliance expectations in contracts, and establishing internal controls and ongoing monitoring to determine compliance with the relevant laws.[25] While these expectations have not formally been discussed in the context of investor relationships, such a discussion could be forthcoming.

ANTICIPATING AND MITIGATING THE RISKS OF INVESTMENT AND INVOLVEMENT IN PORTFOLIO COMPANIES

In light of increased regulatory scrutiny of activities that have traditionally been carried out by private equity firms in managing or overseeing portfolio companies, firms should weigh the risks of various levels of involvement with portfolio companies — both at inception and throughout the existence of the relationship. Firms can mitigate the risk by taking the following steps:

- **Tailor the level of involvement.** The recent enforcement activity suggests that the private equity firm's substantive involvement in the portfolio company heightens liability for the company's misconduct. Private equity firms should therefore evaluate the risks of its involvement with the operational and business decisions of a portfolio company and monitor the implications of their involvement on a regular basis.
- **Understand laws that apply to portfolio companies operating in regulated industries.** Private equity firms should understand the regulatory landscape of the areas in which they invest, including the laws applicable to portfolio company activities. They should also closely monitor investigations and lawsuits against portfolio companies.
- **Conduct periodic reviews.** If the private equity firm is a member of the board or has observer status, the firm should evaluate the business activities of the portfolio company and ensure that it has appropriate controls in place to prevent, detect, and remediate potential violations of applicable law. For example, in a highly regulated space such as consumer finance, private equity firms should conduct a periodic review of licensing to identify potentially unlicensed activities.

24. CFPB, CFPB Bull. No. 2016-02, Service Providers (Oct. 31, 2016), https://files.consumerfinance.gov/f/documents/102016_cfpb_OfficialGuidanceServiceProviderBulletin.pdf; CFPB, CFPB Bull. No. 2012-06, Marketing of Credit Card Add-on Products (July 18, 2012), http://files.consumerfinance.gov/f/201207_cfpb_marketing_of_credit_card_addon_products.pdf; OCC, OCC Bull. No. 2013-29, Third-Party Relationships: Risk Mgmt. Guidance (Oct. 30, 2013), https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.
25. *Id.*

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