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PERSPECTIVE

Private equity firms and PPP fraud liability under the False Claims Act

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The U.S. Department of Justice's increased focus on the private equity sector in recent years has coincided with that sector's growing investment in the highly regulated healthcare and life sciences industries. That increased focus has been further fueled by the CARES Act and its Paycheck Protection Program, which was in operation from April 2020 through May 31, 2021. In March 2021, the DOJ announced new enforcement priorities focusing on CARES Act fraud. Chief among the potential targets are private equity-backed companies. While private equity firms were ineligible for PPP loans, their portfolio companies may have been eligible, and it is likely that prosecutors and private plaintiffs will seek to hold private equity firms liable under the False Claims Act for a portfolio company's actions with respect to PPP loans.

The Small Business Administration released data on the companies that received PPP loans and analysis of this data revealed that over 8,100 privately backed companies were approved for PPP loans of $150,000 or more. Of these, 2,528 were private equity-backed companies. Under the CARES Act, businesses were eligible to receive PPP loans issued by private lenders and credit unions but backed by the SBA. PPP loans were to be used for select purposes including: funding payroll costs and benefits paying mortgage interest, rent, or utilities; and other worker protection costs related to COVID-19. In April 2020, due to confusion about private equity firms' eligibility for the loans, the SBA issued an interim final rule stating that private equity firms were ineligible for PPP loans.

Portfolio companies, however, could continue to qualify for the loans if they met special size requirements under the SBA's affiliation rules. The affiliation analysis under the SBA's rules involves six different bases for affiliation, including ownership, stock options, control, management, identity of interest, and the existence of franchise and license agreements. While this is a fact-specific analysis, for the purposes of the PPP, a private equity firm was likely to be considered an "affiliate" of a portfolio company, and portfolio companies controlled by the same private equity firm were likely to be "affiliates" of each other. Under the rules, if the aggregate number of employees at the borrower and its affiliates exceeded a certain size, the borrower was ineligible for PPP loans. In addition, upon application, borrowers were required to certify in good faith that the loan was necessary, that they satisfied the affiliation rules for size and eligibility, and that they agreed to use the funds appropriately. If these certification requirements are determined to have not been met, the SBA will seek immediate repayment of the loan.

If a private equity firm's portfolio company intentionally applied for a PPP loan using false information, for impermissible uses, or by disregarding affiliation and certification requirements, the private equity firm itself may be at risk for liability. While the DOJ has a number of tools at its disposal to combat fraud, the FCA frequently is used by both the government and private plaintiffs to impose liability on persons and entities that purportedly defraud governmental programs. The FCA has both a civil and criminal component and can result in treble damages. It has already been used to hold at least one internet retail company and its CEO civilly liable for purported false statements made during the PPP application process. The FCA is likely to be a go-to tool for pursuing allegations of PPP loan fraud against private equity firms as well.

While the DOJ is yet to announce an enforcement action against a private equity firm for PPP loan activity, there are a number of recent examples of the DOJ holding private equity firms accountable for conduct by an underlying portfolio company that was alleged to have violated the FCA. For example, in 2019 the DOJ announced a civil FCA settlement with private equity firm Riordan, Lewis & Haden Inc, based on alleged prescription-referral kickbacks paid by a compounding pharmacy DOJ described as "managed" by the private equity firm. In 2020, the DOJ announced a settlement with The Gores Group, a private equity firm, regarding alleged improper sales and promotional practices by a medical device company between 2006 to 2012, even though The Gores Group did not acquire the company until 2012. This past July, the DOJ announced an FCA settlement of $1.8 million with Ancor Holdings LP, a private investment company, for alleged patient-referral kickbacks paid by an EEG testing company that DOJ reported as having a management agreement with Ancor.

These prior enforcement successes suggest that future potential DOJ prosecutions—as well as private whistleblower lawsuits—alleging CARES Act fraud under the FCA will turn not just on a private equity firm's demonstrated involvement in and oversight over the PPP loan activity of the target portfolio company, but also on a private equity firm's purported inaction when it arguably had notice of potentially problematic PPP borrowing by that portfolio company. Indeed, the DOJ may even seek to hold a private equity firm liable for a portfolio company's conduct pre-dating their relationship, particularly if the DOJ believes that the conduct could have been discoverable with due diligence.

Accordingly, as a prudential matter, private equity firms should consider conducting a review of any PPP loan activity on the part of their portfolio companies, starting with loans that involved board notice or approval and the surrounding diligence. Proactively identifying and remediating any arising issues, with consideration given to potential self-disclosure to the government, will help serve to mitigate the risk of future liability. ■

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