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Private Equity Fund Adviser Settles SEC Charges in First Action Over Negligent Misallocation of Portfolio Company Expenses

by Gregory D. DiMeglio, Frank A. Bacelli and Peter L. Tsirigotis

"Advisers that commingle assets across funds must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefiting to the detriment of the other." – Julie M. Riewe, co-chief of the SEC Enforcement Division's Asset Management Unit[1]

On Sept. 22, the Securities and Exchange Commission (SEC) charged Lincolnshire Management Inc., a New York-based private equity fund adviser, with violating the Investment Advisers Act of 1940 by breaching its fiduciary duties to two affiliated private equity funds through the misallocation of expenses between two portfolio companies in a manner that improperly benefited one fund over the other.[2] The SEC also found that Lincolnshire failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act arising from the integration of the two portfolio companies. Without admitting or denying the findings, Lincolnshire agreed to a cease-and-desist order settling the matter and to pay over $2.3 million.

The Lincolnshire settlement represents just the latest example of the SEC's increasing scrutiny of private equity fund advisers and, specifically, their handling of fees and expenses. In May, Andrew J. Bowden, the director of the SEC's Office of Compliance Inspections and Examinations (OCIE), stated that OCIE had identified the treatment of fees and expenses as "by far" the most common deficiency found in its more than 150 examinations of private equity firms.[3] Bowden also highlighted what he described as a "remarkable" and "significant" statistic: "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time." The Lincolnshire proceeding is the first time the SEC has taken enforcement action in this area since Bowden's remarks.

Background

According to the SEC's order, in 2001, Lincolnshire Equity Fund II, L.P. (LEF II), acquired Computer Technology Solutions Corp. (CTS) with the intention of integrating where possible the operations of CTS and Peripheral Computer Support Inc. (PCS), which had been acquired in 1997 by Lincolnshire Equity Fund, L.P. (LEF). Prior to the acquisition of CTS, Lincolnshire disclosed to the limited partners in both LEF II and LEF that it intended to integrate CTS and PCS and jointly sell them. The two companies subsequently integrated their financial accounting systems and a number of business and operational functions, including payroll and 401(k) administration, human resources, marketing, and technology.

They also entered into a joint line of credit, formed a joint management team and marketed through a combined logo.

As part of the integration, the portfolio companies shared numerous annual expenses that generally were allocated between them based on each company's contributions to their combined revenue. There was, however, no written guidance or detail outlining Lincolnshire's expense allocation policy.[4] The SEC found that "[w]hile generally the shared expenses were properly allocated and documented[,] in certain instances, a portion of the shared expenses was misallocated and went undocumented, which resulted in one portfolio company paying more than its share of expenses that benefitted both companies." The SEC's order refers to the following instances of misallocated expenses:

- PCS paid the entire third-party payroll and 401(k) administrative expenses for the employees of both companies.

- The failure to allocate the salaries of employees who performed work that benefited both PCS and CTS.

- CTS's failure to contribute to the general overhead costs of a wholly owned subsidiary of PCS that performed services for, and sold supplies and parts to, CTS at cost and to employees of the subsidiary who performed services for CTS (though such employees' salaries were paid by PCS).

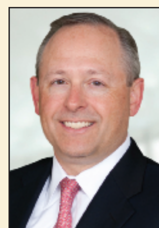
- Upon the joint sale of PCS and CTS, LEF, owner of PCS, paid ten percent of the transaction bonuses for two executives who were solely employees of CTS.

Violations and Remedies

The SEC found that because Lincolnshire had failed to properly allocate these expenses, one portfolio company (and, indirectly, the fund that owned it) paid more than its share for services that benefited both companies. Lincolnshire thereby breached its fiduciary duties to LEF and LEF II in violation of Section 206(2) of the Advisers Act. In addition, the SEC found that Lincolnshire violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder by failing to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act arising from the integration of portfolio companies owned by LEF and LEF II. Lincolnshire agreed to cease and desist from committing or causing future violations of these provisions and to pay $1.5 million in disgorgement, $358,112 in prejudgment interest and a $450,000 penalty.

Takeaways

The Lincolnshire case is significant in a number of respects. First, with charges grounded in no more than simple negligence, the proceeding sheds further light on the ways in which the SEC intends to apply Chair Mary Jo White's "Broken Windows" enforcement philosophy, both generally and as to private equity fund advisers specifically.[5] Second, with factual findings dating as far back as 2005, prior to the date Lincolnshire was required to register as an investment adviser, the matter makes clear that private equity fund advisers should expect careful SEC scrutiny of a significant portion of their books and records. Finally, as noted above, this is the first case against a private equity fund adviser for conduct relating to the negligent misallocation of expenses among its portfolio companies and funds.[6] In light of this proceeding and OCIE Director Bowden's comments earlier this year, private equity fund advisers should review their fee and expense practices to determine whether they are meeting their fiduciary duties to the funds they advise, examine their policies and procedures for compliance with the Advisers Act, and continue to monitor SEC enforcement developments. ▪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[1] *See* SEC Charges New York-Based Private Equity Fund Adviser with Misallocation of Portfolio Company Expenses, SEC Press Release 2014-205 (Sept. 22, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673.

[2] *Id.; In re Lincolnshire Mgmt., Inc.*, SEC Release No. IA-3927 (Sept. 22, 2014), *available at* http://www.sec.gov/litigation/admin/2014/ia-3927.pdf.

[3] Andrew J. Bowden, Speech: Spreading Sunshine in Private Equity (May 6, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541735361.

[4] While the expense allocations were documented in each portfolio company's financial records and subject to review during the respective annual audits, neither portfolio company had any written agreements relating to sharing or allocating expenses.

[5] For a discussion of "Broken Windows," see Mary Jo White, Speech: Remarks at the Securities Enforcement Forum (Oct. 9, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539872100, and Mary Jo White, Speech: Deploying

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the Full Enforcement Arsenal (Sept. 26, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539841202. For other recent private equity enforcement actions consistent with “Broken Windows,” see SEC Charges Private Equity Firm with Pay-to-Play Violations Involving Political Campaign Contributions in Pennsylvania, SEC Press Release 2014-120 (June 20, 2014), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542119853, and *In re* Knelman Asset Mgmt. Group, LLC, and Irving P. Knelman, SEC Release No. IA-3705 (Oct. 28, 2013) (settled enforcement action against the investment adviser to a fund of private equity funds and the adviser’s chief executive officer involving improper distributions to fund investors and violations of the custody and compliance rules under the Advisers Act), *available at* http://www.sec.gov/litigation/admin/2013/ia-3705.pdf.

[6] By contrast, on Feb. 25, the SEC brought an administrative action against a private equity fund adviser and the adviser’s chief executive officer alleging scienter-based fraud under the Securities Exchange Act of 1934, the Securities Act of 1933 and the Advisers Act. *In re* Clean Energy Capital, LLC, and Scott A. Brittenham, SEC Release No. 34-71610 (Feb. 25, 2014), *available at* http://www.sec.gov/litigation/admin/2014/33-9551.pdf. The SEC alleged, among other things, that the respondents improperly allocated to the funds over $3 million in expenses that should have been borne by the adviser and that the adviser did not disclose this to fund investors. Specifically, the SEC alleged that allocating the expenses to the funds was contrary to the funds’ governing documents and to the disclosures in the adviser’s Form ADV, and that the respondents did not otherwise inform investors that the funds would be paying these expenses. As of July 31, the administrative proceeding was stayed pending potential settlement of the action. *In re* Clean Energy Capital, LLC, and Scott A. Brittenham, Admin. Proc. File No. 3-15766, Admin. Proc. Rulings Release No. 1663 (July 31, 2014), *available at* http://www.sec.gov/alj/aljorders/2014/ap-1663.pdf.

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