SEC Brings First Action Against a Private Equity Fund Adviser for Misallocation of Portfolio Company Expenses

On September 22, 2014, the Securities and Exchange Commission ("SEC") charged private equity fund adviser Lincolnshire Management, Inc. ("Lincolnshire") with breaching its fiduciary duty to two of its private equity funds by improperly benefiting one fund over the other by misallocating expenses. As has been widely reported, the SEC has been focusing on the private equity industry. In May, Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, stated that in examining "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 case against Lincolnshire is the SEC's first enforcement action against a private equity firm for its alleged misallocation of expenses among commonly managed funds. Lincolnshire agreed to pay approximately $2.3 million to settle the SEC's charges, including a $450,000 penalty.

The case arises out of Lincolnshire's oversight of the internal allocation of expenses between two portfolio companies owned by two different Lincolnshire-advised funds. In 1997, Lincolnshire Equity Fund acquired Peripheral Computer Support, Inc. ("PCS"), a California-based company that serviced and repaired computer hard drives. In 2001, Lincolnshire Equity Fund II acquired Computer Technology Solutions Corp. ("CTS"), a Texas-based company that serviced and repaired laptop computers and handheld devices. Lincolnshire believed the two companies had valuable synergies, and it intended to integrate the two companies and market them for a combined sale. Lincolnshire disclosed to both funds' investors its intention to integrate and sell the two companies together.

Thereafter, Lincolnshire directed PCS's and CTS's management to integrate certain operations of the two companies. PCS and CTS integrated their financial accounting system, certain business and operational functions, including payroll and 401(k) administration, and aspects of the companies' human resources, marketing, and technology departments. Beginning in 2009, the companies were managed by a joint management team and shared a CEO and CFO, among other executives. Thus, in many regards, the companies operated as one company, although they remained distinct legal entities with separate audited financial statements. They also remained owned by two separately advised funds.

The SEC claims that Lincolnshire breached its fiduciary duty to each fund by engaging in the following practices:

- In certain instances, shared expenses were misallocated and went undocumented, which resulted in one company paying more than its share of expenses that benefited both companies. For example, both PCS and CTS used PCS's third party administrators to provide payroll services and administer the 401(k) program, but PCS paid all of these expenses ($25,000 annually) without reimbursement from CTS.
- Certain employees performed work that benefited both companies, but their salaries were not allocated between the two companies as required under the expense allocation policy.
- PCS's wholly-owned Singapore subsidiary performed services and sold supplies to CTS at cost, but CTS did not contribute to the general overhead costs of running the Singapore subsidiary. In addition, "there were PCS Singapore employees devoted solely to performing work for CTS. CTS reimbursed PCS for the salaries of those specific employees but did not pay any of the costs associated with their office space, their computers, or the local business licenses that PCS had to maintain in order to do business in Singapore."

- In 2013, PCS and CTS were successfully sold to one buyer. PCS's and CTS's executives were paid transaction bonuses, and Lincolnshire Equity Fund, which owned PCS, paid 10% of the transaction bonuses for two executives who were solely CTS employees.

In addition, Lincolnshire was alleged to have violated the Compliance Rule (206(4)-7) under the Advisers Act through the following practices:

- Lincolnshire's general intention was for PCS and CTS to allocate expenses that benefited both companies based on the proportion of each company's revenue to the combined revenue of the two companies. Despite this intention, Lincolnshire failed to implement written guidance regarding the expense allocation policy, and neither CTS nor PCS had any written agreements relating to the allocation of expenses or the parties' rights and obligations to one another.

As a result of the aforementioned allegations, the SEC filed, and Lincolnshire settled, an enforcement action alleging violations of Section 206(2) of the Advisers Act because of the alleged breach of fiduciary duty. Lincolnshire was also charged with failing to adopt and implement written policies reasonably designed to prevent violations of the Advisers Act (as required by Rule 206(4)-7) arising from its integration of the two portfolio companies. Without admitting or denying the SEC's claims, Lincolnshire agreed to pay disgorgement of $1,500,000, prejudgment interest of $358,112, and a civil penalty of $450,000.

In its press release announcing the charges, the SEC emphasized that advisers must "satisf[y] their fiduciary duties to each fund and [prevent] one fund from benefiting to the detriment of the other." It is noteworthy that many of the alleged violations related to conduct that occurred many years ago (as far back as 2005) and before Lincolnshire registered with the SEC as an investment adviser in late March 2012. In addition, the amounts of money involved were small and arguably immaterial to the clients of a manager of $1.7 billion in client assets. There was no allegation the investments performed poorly. Finally, while it is less common for portfolio companies to be integrated to this extent, the rationale adopted by the SEC would likely apply to the allocation of expenses relating to any cross fund investment.

The case was brought under Section 206(2) which imposes liability arising out of negligent breaches of fiduciary duty, as well as Rule 206(4)-7, which imposes strict liability for a failure to have an adequate compliance program, here related to the oversight of the allocation of expenses. Here, there are no allegations that anyone at Lincolnshire was acting with malice or wrongful intent or that Lincolnshire benefitted from the allocations, and this seems to be another example of the SEC's aggressive enforcement approach. In this regard, this case is consistent with a trend we have been seeing toward more non-fraud-based cases in all contexts, not just in the private equity context. For example, the large collection of recent cases for Section 16(a) insider trading reporting violations and Rule 105 short-sale violations. These cases often involve simple mistakes and errors, which in the past might draw attention in an exam deficiency letter, but were unlikely to result in an enforcement matter.

Moreover, the fact that the case is based on a fairly nuanced factual scenario – allocation of expenses between portfolio companies – suggests that the SEC's inquiries are becoming more sophisticated. This new level of sophistication may stem from increased industry experience on the teams leading the private equity exams and investigations.

The case is an important one in that it confirms that the SEC is pursuing the industry aggressively, providing added support to the conclusion that firms are well advised to ensure that they are reviewing their practices.

If you have any questions or would like to learn more about the issues raised by this case, please contact your usual Ropes & Gray advisor.

For the SEC's press release, please click here.

For the Order Instituting Proceedings, please click here.