

INSIGHTS

Lincolnshire Pays \$2.3 Million to Settle SEC Charges of Misallocation of Portfolio Company Expenses

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On September 22, 2014, New York-based private equity firm Lincolnshire Management, Inc. (Lincolnshire) agreed to pay \$2.3 million to settle Securities and Exchange Commission (SEC) allegations that Lincolnshire misallocated portfolio company expenses. The charges against Lincolnshire comprise the SEC's first enforcement action against a private equity firm for alleged misallocation of expenses among commonly managed funds.

The SEC's decision to bring an enforcement action against Lincolnshire for misallocating portfolio expenses comes on the heels of the SEC's recent decision to scrutinize the fees and expenses of companies owned by private equity firms. According to Andrew J. Bowden, Director of the Office of Compliance Inspections and Examinations, a recent agency review identified "violations of law or material weaknesses in controls" at over half of the firms examined since the review's inception.

According to a statement by Julie Riewe, Co-Chief of the SEC Enforcement Division's Asset Management Unit, Lincolnshire breached its fiduciary duty when it decided to "integrate two portfolio companies owned by separate private-equity funds" advised by Lincolnshire, resulting in the "misallocation of expenses between the two companies." The SEC has advised that advisers who wish to commingle assets across funds "must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefitting to the detriment of the other."

The SEC cited several instances in which Lincolnshire breached its fiduciary duty to its funds:

- In certain instances, Lincolnshire misallocated or failed to document shared expenses, resulting in one portfolio company's overpayment of expenses that benefitted both companies. For example, a portfolio company of Lincolnshire Equity Fund paid the entire third-party payroll and 401(k) administrative expenses for employees of companies held both by Lincolnshire Equity Fund and Lincolnshire Equity Fund II.
- Although Lincolnshire developed an expense allocation policy, the policy was not uniformly implemented. Additionally, Lincolnshire did not provide any written guidance regarding the expense allocation policy, and neither portfolio company entered into any written agreements relating to the allocation of expenses or the companies' rights and

obligations.

- Certain employees performed work benefitting both companies, but salaries were not properly allocated as required under Lincoln's expense allocation policy.
- One of the portfolio companies' foreign subsidiaries performed services and sold supplies to the other portfolio company at cost, but the portfolio company receiving such services and supplies did not contribute to the general overhead costs of running the foreign subsidiary.

Lincolnshire, which neither admits nor denies wrongdoing, has agreed to pay a disgorgement of \$1,500,000, prejudgment interest of \$358,112 and a civil penalty of \$450,000.

The enforcement action against Lincolnshire was brought under Section 206(2) of the Advisers Act, which imposes liability on negligent breaches of fiduciary duties, and Compliance Rule 206(4)-7, which imposes strict liability on the failure to implement adequate compliance programs. Importantly, no allegations related to malice or wrongful intent were brought against Lincolnshire, indicating that the SEC's enforcement approach has become more aggressive.

Noteworthy to investment advisors, many of Lincolnshire's alleged violations occurred prior to Lincolnshire's registration with the SEC as an investment adviser. Additionally, the amounts at issue were arguably immaterial for a manager of \$1.7 billion in client assets. Finally, the SEC's rationale in its allegations against Lincolnshire likely could apply to the allocation of expenses related to any cross-fund investment.

Given the SEC's increasingly aggressive enforcement approach and heightened scrutiny of the fees and expenses of portfolio companies owned by private equity firms, investment advisers should review their current compliance programs and expense allocation policies in order to confirm that they have not breached their fiduciary duties. Should you require additional information regarding the Lincolnshire settlement or investment advisers' fiduciary obligations, please contact Cheri Hoff at (212) 508-6175.