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Allocation of Expenses

# Allegations That Private Equity Manager Misallocated Expenses and Failed to Disclose Conflicts of Interest Result in Nearly $3 Million in Disgorgement and Fines

Jan. 17, 2019

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Improper expense allocations and conflicts of interest, which often go hand in hand, are easy and frequent SEC targets. Yucaipa Master Manager, LLC (Yucaipa) landed in trouble on both counts by allocating personnel expenses to its funds when not explicitly permitted by the funds' governing documents; failing to appropriately allocate certain expenses among Yucaipa's clients; and misallocating expenses to its clients that should have been borne by the adviser or one of its principals.

This action is a reminder that advisers must be scrupulous in allocating expenses among themselves and their funds, and that advisers must insist that third-party service providers keep accurate logs of the services they provide to the adviser, its clients and affiliates. This article analyzes the SEC settlement order.

See "OCIE Risk Alert Warns of Six Most Frequent Fee and Expense Compliance Issues" (May 3, 2018); and "Eight Bad Excuses Fund Managers Have Raised Trying to Avoid SEC Sanctions for Fee and Expense Allocation Violations and Undisclosed Conflicts of Interest" (Oct. 13, 2016).

## Respondent and Other Relevant Entities

Yucaipa has been registered with the SEC as an investment adviser since 2012. As of March 2018, it had approximately $2.67 billion in assets under management. In addition to managing the personal assets of the firm's principal (Principal), Yucaipa manages the following private equity funds, which were launched between 2002 and 2008:

- Yucaipa American Alliance Fund I, LP and its parallel investment fund, Yucaipa American Alliance (Parallel) Fund I, LP (together, YAAF I);
- Yucaipa American Alliance Fund II, LP and its parallel investment fund, Yucaipa American Alliance (Parallel) Fund II, LP (together, YAAF II);
- Yucaipa Corporate Initiatives Fund I, LP (YCI I);
- Yucaipa Corporate Initiatives Fund II, LP and its parallel investment fund, Yucaipa Corporate Initiatives (Parallel) Fund II, LP (together, YCI II); and

- Yucaipa American Special Situations Fund, LP (YASSF, and, together with YAAF I, YAAF II, YCI I and YCI II, the Funds).

None of the Funds are registered with the SEC. Most of the Funds' investors are large institutional investors.

Yucaipa had arrangements with two third-party service providers relevant to the SEC order:

- "Consulting Firm A" sourced deals for Yucaipa and advised on certain investments made by YAAF I, YAAF II and YCI II.
- "Consulting Firm B" advised the Principal on two of his or her personal investments and provided services to YAAF II and one of its portfolio companies.

# Fund Structures and Governance

A Yucaipa affiliate advises each of the Funds, and an affiliate serves as each Fund's general partner. Each Fund's limited partnership agreement (LPA) vests management and control of the Fund in Yucaipa or its affiliates.

The LPAs also set forth the specific expenses that may be charged to the Funds, including:

- reasonable fees and expenses relating to the acquisition and disposition of investments, to the extent not reimbursed by a portfolio company or third party;
- reasonable legal, custodial and accounting expenses, including expenses associated with the preparation of the Fund's financial statements, tax returns and schedules K-1; and
- reasonable consulting expenses for services different from those provided by Yucaipa.

For more on expense allocation practices, see our three-part series: "Practices Fund Managers Should Avoid" (Aug. 25, 2016); "Flawed Disclosures to Avoid" (Sep. 8, 2016); and "Preventing and Remedying Improper Allocations" (Sep. 15, 2016); and our two-part series "How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds?": Part One (May 2, 2013); and Part Two (May 9, 2013).

Each Fund has a limited partnership advisory board (LPAB) composed of several of the Fund's limited partners. One of the functions of the LPAB is to evaluate conflicts of interest affecting Yucaipa and its affiliates. Each LPA provides that if Yucaipa or a Fund's general partner is aware of a conflict of interest, it must "be guided by its good faith judgment as to the best interests" of the respective Fund and its investors; disclose the conflict to the LPAB; and act in accordance with the LPAB's instructions regarding that conflict.

See "RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest" (Jan. 21, 2016); and "Proper Use of Advisory Committees by Private Fund Managers May Mitigate Conflicts of Interest" (Dec. 17, 2015).

# Alleged Improper Allocations of Expenses and Undisclosed Conflicts of Interest

## Compensation Related to Tax Preparation

The LPAs provided that the Funds would bear the cost of preparing their financial statements and tax returns. The LPAs, however, also required Yucaipa to bear the costs of its own overhead, including salaries and other compensation of its personnel.

See "Inadequate Disclosure of Expense Allocations May Carry Unintended Consequences" (May 14, 2015).

From 2010 through 2015, Yucaipa charged the Funds an aggregate $570,198, representing a portion of the costs of Yucaipa's in-house tax partner and in-house tax manager, both of whom assisted in the preparation of not only the Funds' tax returns, but also those of Yucaipa, its affiliates and some of the Principal's personal investments.

The SEC claimed that Yucaipa:

- failed to disclose that it was charging the Funds for the Yucaipa in-house tax personnel who assisted in preparing the Funds' returns; and
- failed to adequately disclose to the Funds' investors or their LPABs how it allocated the cost of the in-house tax personnel among Yucaipa, its affiliates and the Funds.

See "Absent Proper Disclosure, Allocation of Manager Expenses to Funds May Bring Significant SEC Penalties" (Sep. 29, 2016); and "Specific Disclosure Before Charging Legal Expenses to Funds May Help Investment Advisers Avoid SEC Scrutiny" (Nov. 19, 2015).

## Fees and Transactions Involving Consulting Firm A

In 2011, Yucaipa agreed to pay a $660,000 success fee to Consulting Firm A on a deal for one of YCI II's portfolio companies. Yucaipa allocated the entire expense to YCI II, despite the fact that the consultant had simultaneously been providing deal-sourcing services to Yucaipa. Similarly, in 2012, Consulting Firm A provided bankruptcy consulting on a YAAF II investment at the same time that it worked with Yucaipa on several investment opportunities. Yucaipa caused YAAF II to pay the consultant's entire fee of $425,000, even though a portion of that fee should have been allocated to Yucaipa.

Yucaipa allegedly failed to disclose either of those payments to the respective Fund's LPABs or investors. It also allegedly failed to require the consultant to keep records of the different work it performed by project, Fund or portfolio company, which would have permitted the proper allocation of expenses among the relevant entities.

In 2012, the Principal made a personal loan of $215,000 to the principal of Consulting Firm A. The loan was secured by monies due to that firm from Yucaipa, its affiliates and the Funds. After making the loan, Yucaipa engaged Consulting Firm A to provide services to YAAF I. Yucaipa used payments YAAF I owed to Consulting Firm A under the 2012 consulting agreement to pay off the loan, and Yucaipa accelerated those payments by one month. Yucaipa, however, never disclosed the Principal's loan or the acceleration of fees to YAAF I's investors or its LPAB.

Finally, in 2013, Yucaipa used YAAF II funds that were reserved to pay Consulting Firm A for work it did for YAAF II to pay YAAF I's obligations to that consultant. Yucaipa failed to disclose that payment to YAAF II's investors or its LPAB.

See "Improper Use by Managers of Fund Cash to Pay Other Funds' Legal Expenses May Result in Serious Penalties" (Sep. 7, 2017).

## Fees and Transactions Involving Consulting Firm B

From 2012 through 2014, Consulting Firm B provided services to YAAF II and one of its portfolio companies. YAAF II, directly or through that portfolio company, paid the consultant $941,377 in the aggregate for those services. During that time, Consulting Firm B also provided consulting services to two businesses in which the Principal held an interest outside of the Funds. The SEC asserted, "While there are no records of the amount of time Consulting Firm B spent on non-Fund ventures, some portion of the fees and expenses paid by YAAF II, either directly or through payments made by [the portfolio company], should have been borne by the non-Fund ventures."

In addition, in May 2014, the Principal made a personal investment in Consulting Firm B, which Consulting Firm B sold to the Principal at a discount in recognition of services the Principal had rendered to it.

Finally, pursuant to YAAF II's LPA, Yucaipa was required to offset a portion of any consulting fees paid by YAAF II to Yucaipa affiliates against the advisory fees payable by YAAF II. After the Principal's investment in Consulting Firm B, the consultant became an affiliate of Yucaipa; thus, Yucaipa should have offset a portion of the fees YAAF II paid to Consulting Firm B against the advisory fees YAAF II paid to Yucaipa.

Yucaipa failed to disclose the circumstances surrounding YAAF II's payment of fees to Consulting Firm B; the Principal's investment in that consultant; or the failure to offset advisory fees to either YAAF II's LPAB or its investors.

For additional coverage of enforcement actions involving fee and expense issues, see "SEC Continues to Scrutinize Accelerated Private Equity Monitoring Fees" (Aug. 23, 2018); "Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action" (Nov. 12, 2015); and "Enforcement Action Against Private Equity Fund Manager Highlights Five Aspects of the SEC's Thinking on Allocation of Expenses" (Sep. 25, 2014).

## Inadequate Policies and Procedures

The nature of Yucaipa's business involved both:

- the use of third-party service providers by Yucaipa, its Principal, its affiliates and its Funds; and
- the allocation of expenses among the respective entities or individual that received those services.

The SEC asserted, "Despite the potential risks surrounding the use of common service providers as well as the allocation of related expenses, Yucaipa failed to adopt written policies and procedures reasonably designed to prevent conflicts of interest arising from the allocations of these expenses and payments."

See "Adviser's Failure to Identify and Disclose Conflict of Interest Arising Out of Its Use of Soft Dollars Results in Compliance Rule Violation" (Sep. 27, 2018).

## Specific Violations

As a result of the alleged misconduct outlined above, the SEC claimed that Yucaipa violated the following provisions of the Investment Advisers Act of 1940 (Advisers Act) and its rules:

- Section 206(2), which prohibits fraudulent and deceptive transactions and practices by advisers;
- Section 206(4) and Rule 206(4)-8, which make it unlawful for an investment adviser to make material misstatements or omissions of fact with respect to investors in pooled vehicles or engage in any act, practice or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle; and
- Section 206(4) and Rule 206(4)-7, which require an adviser to adopt and implement written policies and procedures reasonably designed to prevent violations by the adviser and its supervised persons of the Advisers Act and its rules.

## Cooperation and Remediation

In reaching the settlement, the SEC took into account Yucaipa's cooperation with SEC staff; its voluntary reimbursement of $940,244 to the Funds for expenses improperly charged to them; its expansion of its compliance department; and its enhancement of its written policies and procedures.

## Sanctions and Undertakings

Without admitting or denying the SEC allegations, Yucaipa has agreed to:

- cease and desist from violating the referenced provisions of the Advisers Act and its rules;
- pay disgorgement of $1,863,242 and prejudgment interest of $71,070, which is to be paid into a disgorgement fund administered by Yucaipa and distributed within the next 90 days to affected Funds as a credit or reduction of fees that the limited partners of those Funds (other than Yucaipa affiliates) would otherwise be obligated to pay to Yucaipa; and
- pay a $1-million civil penalty.

In addition, Yucaipa has agreed to retain an independent compliance consultant acceptable to the SEC to "[c]onduct a comprehensive review of Respondent's current policies and procedures relating to conflicts of interest and expense allocation. . . ." The consultant must make recommendations for improving those policies and procedures and conduct a review of their implementation and effectiveness one year after issuance of its original report. Yucaipa may suggest alternatives to any of the consultant's recommendations that Yucaipa considers to be "unduly burdensome or impractical," but it must promptly abide by and implement the consultant's final recommendations. As is customary, the consultant and its affiliates are prohibited from being employed by Yucaipa or its affiliates for two years after the engagement ends.