

# SEC Enforcement Against Private Equity Advisers Continues

December 18, 2018

On December 13, 2018, the U.S. Securities and Exchange Commission (“SEC”) announced a settled enforcement action against private equity adviser Yucaipa Master Manager, LLC (“Yucaipa”) for alleged negligent failure to disclose conflicts of interest and misallocation of fees and expenses to the funds it advised.<sup>1</sup> The action originated from concerns raised by staff from the Office of Compliance Inspections and Examinations. Yucaipa paid nearly \$3 million to resolve the case.

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The SEC’s order faulted Yucaipa for not providing pre-commitment disclosure that compensation of in-house employees who assisted in preparing the funds’ tax returns would be allocated to fund clients and not describing how the allocation would be executed. The order also discusses conflicts that might arise in connection with the use of third-party service providers who provide services to the funds but have other connections to the adviser. In particular, the order found that Yucaipa allegedly failed to disclose conflicts of interest stemming from (i) a personal loan from a Yucaipa principal to a consulting firm principal that was secured with the fee stream the funds owed to the consulting firm, (ii) Yucaipa’s use of the resources of one fund to pay the contractual obligations of a different fund to the consulting firm and (iii) a Yucaipa principal’s 25 percent investment in a consulting firm used by the funds (and the related failure by Yucaipa to offset the consulting firm’s fees against its management fee after the principal’s investment made the consulting firm a Yucaipa affiliate).

### MISALLOCATION OF COMPENSATION OF INTERNAL EMPLOYEES

From 2010 to 2015, Yucaipa charged the funds \$570,198, which was a portion of the costs of two of its employees — an in-house tax partner and in-house tax manager (who was an independent contractor from 2013 to 2015). These two Yucaipa employees assisted and supplemented the work of more expensive outside providers in preparing the funds’ tax returns, as well as the tax returns for Yucaipa, its affiliates and some of the

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<sup>1</sup> In the Matter of Yucaipa Master Manager, LLC, Investment Adviser Release No. 5074 (Dec. 13, 2018), available [here](#).

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principal's personal investments. The SEC's order found that, while the relevant limited partnership agreements ("LPAs") state that the costs of preparing the funds' tax returns are a fund expense, "the costs and expenses incurred by the [m]anager in providing for its or the General Partner's normal operating overhead, including salaries, other compensation and benefits of the Manager's employees" will be borne by Yucaipa rather than the funds. As a result, the order found that, without pre-commitment disclosure, Yucaipa was not permitted to allocate to its funds any portion of its employees' time spent preparing fund tax returns. The order also found that Yucaipa did not disclose the methodology it was using to allocate its employees' time to the funds. This aspect of the order demonstrates the importance of specifically addressing the allocation of adviser overhead expenses (including salaries) in LPAs and related disclosures. Also of note, the order provides another example of instances where contractors may be viewed by the SEC as insiders.

### MISALLOCATION OF CONSULTANTS' EXPENSES

The SEC's order also found that Yucaipa's use of consultants raised a number of conflicts of interest. In several instances, Yucaipa allegedly allocated all of the fees payable to consulting firms to the funds rather than allocating to Yucaipa a portion of the fees attributable to the services provided to Yucaipa.

#### **Simultaneous Projects for Adviser and Fund**

The SEC's order found that a Yucaipa-advised fund paid a consulting firm ("Consulting Firm A") \$425,000 for operating expenses during a period in which Consulting Firm A was providing bankruptcy consulting on a fund investment and, separately, deal sourcing to Yucaipa. The order found that even though some portion of the \$425,000 expense was properly allocable to Yucaipa, Yucaipa improperly allocated it entirely to the fund. In a similar instance, Yucaipa agreed to pay \$660,000 to Consulting Firm A as a success fee for sourcing and closing a deal at the same time that Consulting Firm A was investigating other investment opportunities for a portfolio company. Yucaipa, however, failed to allocate the appropriate portion of the success fee to itself and instead allocated the entire fee to a client fund. In neither instance, however, was the SEC's order explicit as to why Consulting Firm A's services were viewed as allocable in part to Yucaipa.

#### **Simultaneous Projects for Principals' Personal Ventures and Fund**

In 2012, a Yucaipa fund and one of its portfolio companies paid a talent management and marketing company ("Consulting Firm B") approximately \$940,000. During this time, Yucaipa's principals had also engaged Consulting Firm B for unrelated personal ventures. The SEC's order found that some portion of fees and expenses paid by the

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fund and fund portfolio company should have been borne by the principals and that Yucaipa failed to allocate the appropriate portion to itself.

### **FAILURE TO DISCLOSE CONFLICTS OF INTEREST**

The SEC's order also found that Yucaipa failed to disclose various conflicts of interest arising from a principal's loan to Consulting Firm A, a principal's investment in Consulting Firm B and the misallocation of expenses between funds (as well as related failure to offset fees). The order describes several examples of these conflicts.

#### **Loans to Service Providers<sup>2</sup>**

Prior to Yucaipa entering into the consulting agreement with Consulting Firm A, Yucaipa's principal had personally loaned \$215,000 to a principal of Consulting Firm A. Under the terms of the loan agreement, the loan was secured by money that Yucaipa or its funds might owe to Consulting Firm A. Yucaipa used payments owed from one of the funds to repay the loan and also accelerated payments from the fund to Consulting Firm A by one month to enable the repayment. Yucaipa's principal earned \$1,554 in interest on the personal loan.

#### **Principal's Undisclosed Investment in a Service Provider<sup>3</sup>**

Later, in 2014, while Consulting Firm B continued to provide services to a fund portfolio company, one of Yucaipa's principals made a personal investment in Consulting Firm B, obtaining a right to 25 percent of its profits, which Consulting Firm B sold to the principal at a discount "[i]n recognition of the services the [p]rincipal rendered to Consulting Firm B."

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<sup>2</sup> The SEC has brought other loan-related conflicts cases involving private equity advisers. See, e.g., In the Matter of Norman M.K. Louie and Mount Kellett Capital Management LP, Investment Adviser Release No. 4968 (July 16, 2018) (failure to disclose loan from lead portfolio manager of a fund holding the largest position in public company to public company's CEO and failure to timely file Schedule 13D), [available here](#); In the Matter of Aisling Capital LLC, Investment Adviser Release No. 4951 (June 29, 2018) (failure to offset certain consulting fees a venture capital fund adviser received against management fees paid by funds it advised), [available here](#); In the Matter of JH Partners, LLC, Investment Adviser Release No. 4276 (Nov. 23, 2015) (failure to disclose loans from adviser and its principals to fund portfolio companies), [available here](#); In the Matter of Clean Energy Capital, LLC and Scott A. Brittenham, Investment Advisers Release No. 3785 (Feb. 25, 2014) (failure to disclose loans from manager to the funds using fund assets as collateral), [available here](#).

<sup>3</sup> See, e.g., In the Matter of Centre Partners Management, LLC, Investment Adviser Release No. 4604 (Jan. 10, 2017) (failure to disclose potential conflicts of interest arising from principals' investment in a service provider), [available here](#).

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#### Misallocation of Expenses Between Funds<sup>4</sup>

In one instance where a fund did not have sufficient cash to pay Consulting Firm A, Yucaipa used available cash in a different client fund to satisfy the other fund's obligation.

#### FAILURE TO OFFSET FEES RECEIVED BY AN AFFILIATE

The SEC's order also found that Yucaipa improperly failed to offset certain fees. In particular, following a principal's personal investment in Consulting Firm B as described above, Yucaipa failed, per the LPA, to offset 70 percent of the consulting fees received by Consulting Firm B (which had become a Yucaipa affiliate after the principal's investment) from a fund portfolio company against the advisory fees Yucaipa received from the fund.<sup>5</sup>

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Based on the above-described issues, the SEC's order found that Yucaipa violated Sections 206(2) and 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rules 206(4)-7 and 206(4)-8 thereunder as a result of its failure to disclose to fund investors or the advisory boards the conflicts of interest described above and its failure to adopt and implement compliance policies and procedures to address the allocation of fees, expenses and payments among Yucaipa, the funds, the funds' investments and the principal's personal investments. It is worth noting that because the SEC only instituted the matter pursuant to Section 203(k) of the Advisers Act, the order did not find that Yucaipa's violations of the anti-fraud provisions were "willful." The SEC ordered Yucaipa to engage an independent compliance consultant and pay nearly \$2 million in disgorgement and prejudgment interest and a \$1 million penalty. Yucaipa also voluntarily reimbursed the funds approximately \$940,000 for expenses improperly charged and expanded the size of its compliance department.

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Please do not hesitate to contact us with any questions.

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<sup>4</sup> The SEC has brought other enforcement cases involving misallocation of expenses across portfolio companies. See, e.g., In the Matter of Lincolnshire Management, Inc., Investment Adviser Release No. 3927 (Sept. 22, 2014), available [here](#).

<sup>5</sup> See, e.g., In the Matter of WCAS Management Corporation, Investment Adviser Release No. 4896 (April 24, 2018) (failure to disclose conflict of interest resulting from agreement with service provider to funds' portfolio companies wherein manager received a share of the revenue the service provider received as a result of portfolio company purchases), available [here](#).

**NEW YORK**



Jonathan Adler  
jadler@debevoise.com



Andrew J. Ceresney  
aceresney@debevoise.com



Rebecca F. Silberstein  
rfsilberstein@debevoise.com



Norma Angelica Freeland  
nafreeland@debevoise.com

**WASHINGTON, D.C.**



Kenneth J. Berman  
kjberman@debevoise.com



Robert B. Kaplan  
rbkaplan@debevoise.com



Julie M. Riewe  
jriewe@debevoise.com



Jonathan R. Tuttle  
jrtuttle@debevoise.com



Gregory T. Larkin  
gtlarkin@debevoise.com