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Principal Transactions

SEC Fines PE Sponsor, CEO and CFO for Improper Principal Transactions and Expense Allocations

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Limited partnership agreements (LPAs) are carefully negotiated and establish key components of the relationship between general partners (GPs) and limited partners (LPs). Because LPAs may sometimes receive minimal attention post-execution, investors are increasingly demanding that processes be in place to ensure that GPs comply with LPA provisions. Aside from appealing to LPs, this can mitigate the risk that violations by private equity (PE) sponsors will attract SEC scrutiny.

In a recent example of that risk, the SEC settled enforcement proceedings against PE sponsor Corinthian Capital Group, LLC (Corinthian), its CEO and its chief financial officer (CFO) for improper affiliate transactions and expense allocations resulting from failures to properly interpret and implement the LPA. This article details the conduct giving rise to the proceedings, as well as the terms of the SEC settlement order.

For coverage of other recent SEC enforcement actions, see "Neuberger Berman's PE Adviser Faces $2.73 Million in Fines and Disgorgement for Improperly Allocating Employee Compensation to Its Funds" (Mar. 19, 2019); and "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).

Respondents and Other Relevant Entities

Corinthian has been registered with the SEC as an investment adviser since 2012 and advises two PE funds: Corinthian Equity Fund, LP and Corinthian Equity Fund II, LP (Fund). Corinthian managed $270 million on a discretionary basis as of December 31, 2017.

Peter B. Van Raalte co-founded Corinthian in 2005 and has been the CEO of the firm since 2012. He holds a 45-percent ownership stake in Corinthian, acts as its managing member and sits on its investment committee.

David G. Tahan, a licensed CPA in New Jersey, joined Corinthian as CFO on March 10, 2014, and held that position until he resigned from his day-to-day duties on March 11, 2016. Tahan remained on Corinthian's payroll after his resignation, however, and provided services on an as-needed basis until July 31, 2016. He also served as Corinthian's chief compliance officer (CCO)

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from approximately April 2014 until December 2015. Tahan was never a principal or owner of the firm.

For more on serving as a dual-hatted CCO, see our two-part series: "Benefits of Having a Dual-Hatted GC/CCO, and Alternative Solutions for Fund Managers" (Apr. 30, 2019); and "Challenges and Recommendations for Simultaneously Serving as GC and CCO of a Fund Manager" (May 7, 2019).

The Fund was formed in 2013 to invest in small and middle-market companies valued between $50 million and $250 million. Investors committed approximately $130 million in capital, and Corinthian managed the Fund at all relevant times.

Relevant LPA Provisions

The Fund's LPA requires its LPs to pay advisory and other fees and expenses to Corinthian, including a management fee that reflects a fixed percentage of the LPs' total capital commitments. Certain LPs are exempt from paying the management fee, however, including Corinthian's affiliates. The LPA also requires the LPs to pay organizational expenses, although placement fees are specifically excluded from these expenses.

The LPA also contains a "deemed contribution" provision, which permits certain LPs affiliated with Corinthian to satisfy up to 80 percent of their capital call obligations for an acquisition without contributing money. LPs that do not participate in the deemed contribution must provide additional funds to cover the monetary shortfall, but their management fees are offset by this funded amount.

For example, if an eligible LP elects to satisfy a $1-million capital call via a deemed contribution, that LP must pay $200,000, and the remaining $800,000 is made up by other LPs that do not participate in the deemed contribution provision. The LPs that cover the shortfall are entitled to an $800,000 offset to management fees. If the offset exceeds the management fees, it is carried forward and applied to future management fees.

For coverage of tax issues relevant to deemed contributions, see "New Tax Law Carries Implications for Private Funds" (Feb. 1, 2018).

Failure to Apply Offsets for Deemed Contributions

Corinthian did not permit deemed contributions to satisfy the capital call for the Fund's first acquisition. When a subsequent capital call was made for the Fund's second acquisition, however, deemed contributions were allowed. In addition, Corinthian permitted deemed contributions to apply retroactively for the first capital call. The LPA is silent as to whether the deemed contribution provision can be applied retroactively.

As implemented, the deemed contribution provision was available only to Corinthian's principals. The principals' capital call notices for the second acquisition reflected a net credit for their cash overpayment for the first capital call. The credits totaled approximately $1.9 million and were due to Van Raalte and the two other principals of Corinthian.

Corinthian did not apply a management fee offset to the shortfall amounts from the retroactive deemed contribution. If a management fee offset had been correctly applied to the first capital call (and a separate GP default had been addressed), then the Fund's obligation to pay

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management fees and cover the deemed contribution would have been reduced by approximately $1.4 million. In addition, the Fund's obligation to pay the deemed contribution credit to Van Raalte and two other principals would have been reduced from approximately $1.9 million to about $500,000.

The investment committee (including Van Raalte) and other employees of Corinthian (including Tahan) were responsible for reviewing and interpreting the LPA.

Repayment of Corinthian's Credit Line

Corinthian had a line of credit with a bank that included a "clean-up" provision requiring Corinthian to repay the balance every 12 months. Corinthian was permitted to draw on the line of credit 15 days after the balance was paid in full.

See our two-part series on trends in the use of subscription credit facilities: "Advantages for PE Investors and Sponsors Have Led to Adoption by Some Hedge Funds and Credit Funds" (Jan. 24, 2019); and "Structuring Considerations Negotiated With Lenders and Important LPA and Side Letter Provisions" (Feb. 7, 2019).

In October 2014, $2.8 million was outstanding on the line of credit, but Corinthian lacked sufficient funds to repay that balance on the due date. To make the required payment, Corinthian directed the Fund to withhold the deemed contribution credits from Corinthian's principals (thought to be $1.9 million) and transferred $1 million of those funds to its own bank account.

Because Corinthian failed to retroactively apply the management fee offset against the deemed contribution for the first capital call (and failed to address another GP default), it incorrectly calculated the credits due to the principals. In fact, because the principals were owed only about $500,000 in deemed contribution credits, Corinthian overdrew approximately $500,000 from the Fund.

In addition, Corinthian was not authorized by the LPA or otherwise to borrow from the Fund's assets, regardless of whether those assets were owed – or believed to be owed – to Corinthian or its principals. Corinthian had not carried out such transactions between itself and the Fund, which were performed by Tahan, prior to October 2014.

Other Improper Transactions

In addition to the funds used to satisfy the clean-up provision, Corinthian made two transfers from the Fund's bank account to its own account. On October 31, 2014, $78,614 was transferred for payroll expenses, which was repaid, without interest, on December 8, 2014. Also, $100,000 was transferred for operating expenses on December 12, 2014.

By February 3, 2015, Corinthian had transferred approximately $1.9 million from the Fund to Corinthian's principals. On that date, however, Corinthian still retained $600,000 of the Fund's assets that were not repaid to the Fund until February 9, 2015. This means that Corinthian overdrew that $600,000 from the Fund for a six-day period. Each of these money transfers were also performed by Tahan.

Improper Charges for Expenses

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The Fund was responsible for up to $1.5 million of the organizational expenses incurred by Corinthian. Between March 2014 and March 2016, Tahan was responsible for tracking organizational expenses. He reported to Van Raalte and the investment committee, which used the information to determine the amount charged to the LPs.

Before Tahan joined the firm in March 2014, Corinthian called capital from investors based on actual and estimated organizational expenses. Corinthian transferred a portion of those monies from the Fund to Corinthian based on estimates, before the expenses were actually incurred. Tahan continued that practice upon joining Corinthian by transferring monies from the Fund based on amounts incurred in the prior year's audited financial statements and estimated future expenses. Charging the Fund for expenses that were not actually incurred – a practice of which Van Raalte was aware throughout - was not permitted by the LPA.

Corinthian also misclassified certain expenses, including placement fees, as organizational expenses and charged them to the LPs. Most of the misclassifications occurred before Tahan joined Corinthian, and he relied on the incorrect classifications when tracking and reporting subsequent organizational expenses. Van Raalte was aware that placement fees were not considered organizational expenses, but he failed to provide Tahan with adequate guidance or to review the expense classifications.

The totality of Corinthian's errors caused the LPs to overpay $588,394 for organizational expenses in 2014.

For other SEC enforcement actions targeting PE expense allocation practices, see "SEC Fines PE Fund Manager for Failing to Equitably Allocate Fees and Expenses to Its Affiliate Funds and Co-Investors" (Mar. 26, 2019); and "SEC Continues to Scrutinize Accelerated Private Equity Monitoring Fees" (Aug. 23, 2018).

Custody Rule Violations

Corinthian engaged a firm to audit the Fund's financial statements for the 2014 calendar year. From April 2015, the auditor identified the issues with organizational expenses and transfers from the Fund's accounts. Consequently, the auditor withdrew from its engagement on September 29, 2015, and also withdrew its unqualified opinion on the Fund's financial statements for the 2013 calendar year.

Corinthian engaged a replacement auditor, and certain remedial steps were taken to address the issues that had been identified. The Fund's audited financial statements for the 2013 and 2014 calendar years were issued on April 7, 2016, with subsequent audited financial statements for the 2015 calendar year issued on June 16, 2016.

The Fund's financial statements for calendar years 2013-2015 were therefore issued more than 120 days after the end of each fiscal year. Corinthian did not comply with Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act) – the so-called "custody rule" – in any other manner and, as a result, was in breach for all three years.

See "Advisers Must Ensure Auditor Independence to Satisfy Custody Rule" (Nov. 1, 2018).

Failure to Supervise

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Van Raalte supervised Tahan's activities, including the execution of transfers between the affiliate accounts and his accounting of expenses and credits. Van Raalte (and other Corinthian professionals) considered the interpretation of the LPA when deciding to retroactively apply the deemed contribution provision for the first capital call, but they failed to implement the appropriate management fee offset.

In addition, Van Raalte relied on the inaccurate existing classifications for organizational expenses; failed to adequately supervise Tahan when he made transfers between the Funds' and Corinthian's bank accounts; and failed to obtain sufficient details of the specific nature of the transfers to determine whether they were appropriate.

Corinthian's Policies and Procedures

The SEC found that Corinthian lacked reasonable policies and procedures to review transactions between the Fund and Corinthian to ensure they complied with the LPA. Tahan managed both the Fund's and Corinthian's accounts without appropriate oversight or guidance, and Van Raalte relied on Tahan. Although Van Raalte and other individuals within Corinthian had access to bank statements, none of them reviewed them or the associated bank account reconciliations.

Finally, there were no policies or procedures in place about charging the Fund for organizational expenses. Informal practices instituted under a former CFO gave broad discretion to estimate and classify organizational expenses, which continued when Tahan became CFO. While the CFO tracked the organizational expenses and the investment committee determined the amount to be charged to the Fund, there were no mechanisms or processes to ensure the accuracy of those estimates or classifications.

See "Will Inadequate Policies and Procedures Be the Next Major Focus for SEC Enforcement Actions?" (Nov. 30, 2017).

Violations and Sanctions

Corinthian's failure to apply the management fee offset to the retrospective deemed contribution and the excess expenses charged to the Fund were discovered by its former auditor in mid-2015. By the end of 2015, Corinthian had repaid the management fee offset and fully reimbursed the expenses to the Fund, with interest.

When deciding to accept the settlement offer, the SEC took into consideration the remedial steps taken by Corinthian, as well as its cooperation with SEC staff during its investigation.

As a result of the alleged misconduct outlined above, the SEC claimed that Corinthian violated the following provisions of the Advisers Act and its rules:

- Section 206(2) of the Advisers Act, which prohibits investment advisers from engaging in fraudulent or deceptive conduct;
- Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibits investment advisers to pooled investment vehicles from making false statements or misleading omissions about material facts, and from engaging in fraudulent, deceptive or manipulative conduct;
- the custody rule, which requires investment advisers with custody of client assets to have independent public accountants conduct surprise examinations of those client funds or

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securities, or to have any private fund clients distribute timely annual audited financial statements to their investors; and

- Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires investment advisers to adopt and implement written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and its rules.

The SEC also claimed that Van Raalte failed reasonably to supervise Tahan within the meaning of Section 203(e)(6) of the Advisers Act.

In response to the SEC's enforcement action, and without admitting or denying the SEC's findings, it was agreed that:

- Corinthian and Tahan will cease and desist from violating the above provision of the Advisers Act and its rules;
- Corinthian is censured; and
- civil penalties will be paid by Corinthian ($100,000), Van Raalte ($25,000) and Tahan ($15,000).

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