

Valuation

Strategies for Avoiding Valuation Disputes in Connection with Breakups of Hedge Fund General Partnerships

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In many cases, domestic hedge funds are structured as limited partnerships with a general partner receiving the performance allocation and a separate limited liability company serving as the investment manager and receiving an asset-based investment management fee. In such structures, the general partner itself may be a limited partnership or limited liability company, with the principals of the hedge fund manager serving as the limited partners or general partner, or members or managing member. (Such limited partners, general partner, members or managing members are collectively referred to herein as “GP limited partners.”) The formulas by which GP limited partners are compensated are complex, and the stakes are frequently high. In the best case scenario, the complexity inherent in valuing many of the assets held by hedge funds makes it challenging to accurately effectuate the compensation formulas for GP limited partners. However, the challenge is compounded when a GP limited partner seeks to leave a hedge fund general partnership, and the challenge is further compounded when the hedge fund holds illiquid or esoteric investments.

Business “divorces” are always difficult. But in the case of a hedge fund, the difficulties are much greater than in the termination of other business arrangements. Redeeming the holdings of GP limited partners, and estimating the impact on investors, requires an accurate valuation of the fund’s current assets and a reliable estimate of its future performance. Both, and especially the latter, are extremely hard to arrive at. A typical and often effective solution is to apply a series of alternative valuation methodologies. But

this approach creates added challenges because it can produce widely disparate results.

Yet the worst case is to leave the valuation methodology and the terms of the distribution rights unaddressed or unclear in employment agreements or other documents embodying the formulas for compensating GP limited partners. The combination of illiquid investments, ambiguous general partner distribution, redemption or compensation rights, and unclear valuation methodologies is a perfect recipe for litigation. And litigation among GP limited partners can be especially costly to hedge funds and their managers: it may lead to disruption of the fund’s trading strategy and may also result in a loss of investor confidence.

To achieve an efficient and harmonious breakup, guidelines are needed. With the goal of helping hedge fund managers structure and implement such guidelines, this article discusses: the process by which hedge fund general partnership interests and hedge fund assets are valued; the valuation implications of the departure of a GP limited partner; three specific alternative valuation methods for valuing GP limited partnership interests; consequences of ambiguously drafted or nonexistent distribution agreements; specific guidelines for drafting valuation guidelines in hedge fund general partnership agreements (including a four-part taxonomy of hedge fund strategies for valuation purposes); and two case studies in which GP limited partners took opposing approaches to providing a valuation methodology for departing partners, with radically different results.

*Hedge Fund Asset Valuations, General Partnership
Interests and Breakup Agreements*

As indicated, domestic U.S. hedge funds are frequently structured as Delaware limited partnerships. The hedge fund manager is frequently structured as a limited liability company or limited partnership (often in Delaware), and enters into an investment management agreement with the hedge fund under which the manager provides services in exchange for an asset-based investment management fee, often calculated as one to two percent of net assets under management. Also, hedge fund managers frequently set up affiliated general partnerships to receive a performance allocation payable by the hedge fund and calculated as a percentage of annual gains, often 10 to 20 percent. The limited partners in the general partnership frequently are the principals of the hedge fund manager, and the general partner of the general partnership frequently is an entity which in turn is owned by a smaller subset of the principals of the hedge fund manager.

The investment by the general partner in the hedge fund (which is structured as a limited partnership) historically has enabled the GP limited partners to retain the character of the items comprising the performance allocation. However, the tax benefits of such structuring may be largely eliminated if the carried interest provisions in the financial overhaul bills now in conference become law, as they are likely to.

In any case, GP limited partners frequently have contractual rights, embodied in employment agreements or separate agreements, to a portion of the performance allocation earned by the general partnership and, on occasion, to a portion of the management fee earned by the hedge fund manager. In addition, the GP limited partners frequently are investors

(i.e., limited partners) in the hedge fund itself. The value of the general partnership as a whole depends on the expected future cash flows to be generated by the partnership, the lion's share of which will come from performance allocations.

Accordingly, the valuation of each GP limited partner's share in the general partnership depends on the valuation of the funds' assets both at a given point in time and over time.

Arriving at such a dual valuation – involving both a present snapshot and a historical valuation over time – is a challenge in itself. It becomes that much more of a challenge when the assets in question are esoteric derivatives (e.g., options, forwards, swaps, or currency arbitrage positions). Often there is no third-party trading value upon which to determine the portfolio's valuation.

The exit of a GP limited partner makes the situation more difficult still. With the exit of a GP limited partner, the distribution of that partner's share must be determined based on both historical capital that the partner may have invested in the general partnership (which is usually minimal) and the partner's share of the value in the general partnership. To value the partner's share in the general partnership, one must value the partnership itself, which is a function of expected future performance and the underlying value of the assets held by the fund. So the valuation must encompass past, present and future.

Given that all these factors determine the payout, along with an estimate of the changes in investment strategy that will result from the departure of one of the partners, it is essential to understand and anticipate such a departure and provide a way to determine how to liquidate distributions in the general

partnership agreement or a separate partnership breakup agreement.

Different Methods, Different Results, and the Probability of Commencement of Litigation

Hedge fund that holds illiquid or esoteric investments are inherently difficult to value, and are susceptible to widely disparate opinions on what the fund value and change in value might be.

Income Approach

Alternative valuation methods can be applied to value fund assets and changes in value over time. For example, one could take an income approach, trying to value the fund assets or management company by forecasting out future returns or cash distributions based on past performance, and then discounting these returns based on expected returns given the riskiness of the investment strategy.

This income approach, while intuitively appealing, depends on subjective estimates of future expected returns and perceived investment risk, and frequently merits the often-used caveat: “past results cannot be used to predict future fund performance.” Another issue is that it may be particularly problematic to value the shares of a departing partner, because such a departure usually signals a change in investment strategy. This makes past performance as an indication of the future even less reliable.

Peer Comparable Approach

Alternatively, as in other types of valuations, one may use a peer comparable approach with data on public valuations or on transaction multiples. However, these methods depend

critically on the availability of public data upon which to draw such conclusions – something that almost by definition does not exist for hedge fund managers, the majority of whom are not public entities. In the rare cases where such data does exist, it is necessary to ensure that such comparisons are applicable (apples-to-apples). The limited information on public funds or management companies must be similar in type to the partnership one is attempting to value.

Arbitrage-Based Mathematical Formulas

Finally, for options, derivatives and similar assets, one may use arbitrage-based mathematical formulas such as binomial trees or Black-Scholes option pricing formulas, where data on current valued assets are used to derive a synthetic derivative security that under no arbitrage conditions must be valued equally to the underlying derivative. However, these formulas sometimes suffer from a lack of transparency and often can be very sensitive to alternative model assumptions that are difficult to verify.

These are just three sets of the many other alternative valuation schemes. They will sometimes lead to similar outcomes for the valuation of fund assets and changes in fund value over time, but it is far more likely that they will lead to widely disparate opinions on the value of the fund and general partnership.

All of these challenges lead to one conclusion: It is necessary to foresee the ambiguities in the valuation of GP limited partnership interests and develop guidelines for the valuation of such interests to be used in breakup agreements or provisions. Specifically, it is important to set forth the methodologies that will be used to value the general partnership if the makeup of the partnership changes, and to spell out the methodologies before the breakup occurs.

Problems Multiply When Partner Distribution Agreements are Nonexistent, Ambiguous or Incomplete

Breakup agreements typically contain information on proportioned partner ownership interests, that is, the percent or proportion of ownership that each GP limited partner owns in the partnership; the sum of all proportionate interests should equal 100 percent. Such agreements also often contain a formula for payments to GP limited partners upon redemption. But the agreements are often ambiguous about how to determine the value of the GP limited partner redemption, or, more often, rely simplistically on the techniques used to assess NAV, fees and performance in the fund's reporting to investors. This does not fully capture the value of the general partnership itself or the impact of a partner's departure on future strategies and therefore on future performance.

In cases where the agreement specifies the proportioned interest of the GP that belongs to each partner, but includes no guidance as to how the partnership itself or the redemption will be valued, there can be very costly consequences when breakups occur. Absent unambiguous guidelines to determine how partnership interests should be valued, the courts are left as the only avenue to settle such potential disputes.

Litigation is risky for both the remaining and the departing partners. One group of partners may win at the expense of the other or all may lose big. And the valuation of partnership interests is left in the hands of the court.

The alternative is to create guidelines for the valuation of the GP limited partner interests in the event of breakup.

However, even if guidelines have been established to anticipate litigation risk, guidelines by themselves are not the answer. The presence of guidelines resolves ambiguity, but the lack of ambiguity is merely a necessary condition – not a sufficient condition – to solve the problem. To be effective, the guidelines must contain certain characteristics that make them tenable.

Guidelines for Creating Guidelines

Although there is no magic formula for setting valuation guidelines, there are certain principles that should be followed in order to achieve an efficient and non-litigious breakup:

Have Guidelines in Place

The first and most important point is to have guidelines in place. Without them, there will be no direction on valuation. That in turn will lead each party to seize opportunistically on one of many alternative outcomes. Without any agreed-upon guidelines prior to the formation of the general partnership, a wide range of potential valuation approaches can and will be used – leading to multiple conflicting valuations that will result in the event of breakup.

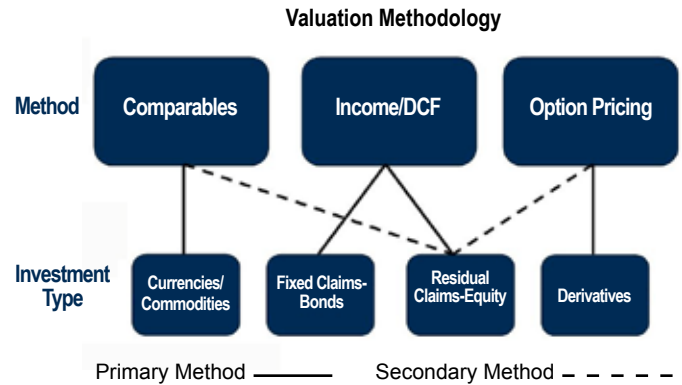
Categorize

Second, divide (categorize) and conquer. Different asset types and investment strategies require different valuation techniques; different investment strategies will result in different expected returns and lumping all of these together into one valuation technique or a single valuation parameter within the model can lead to huge distortions.

Generally, hedge fund investment strategies can be categorized, for valuation purposes, into four general types

of investments: fixed claims, residual claims, derivatives and currencies/commodities. Each of these investment types is described more fully immediately below, and the primary and secondary valuation methodology applicable to each is illustrated in the figure below.

- Fixed claims such as bonds can be valued using a discounted cash flow (income approach) model because cash flows are at least in theory relatively straightforward to predict. Discount rates on many different types of fixed claims are available, which can be used to estimate the expected return or yield on these instruments.
- Residual claims, such as equities, offer more challenge in terms of predicting future cash flows. Thus, the income approach should be supplemented with the peer multiple (or comparable) approach in order to triangulate towards an appropriate valuation.
- Derivative securities can be valued using formulas that are based on forming a perfect synthetic security with assets whose valuations are known. This arbitrage approach to valuations leads to the use of such models such as the Black-Scholes option pricing formula, where known inputs are placed into the model and the derivative security is valued accordingly. Such models, although somewhat complex, have become increasingly popular in valuing not only derivatives but also residual claims, fixed claims and particular trading strategies.
- Currency and commodity assets are generally well traded in public markets, where there is data on spot (or current) prices as well as expectations related to future prices. These types of assets lend themselves well to using the public comparison approach.



Incorporate Past Performance and Future Assumptions

Third, consider the impact of past strategies and performance, but also consider future portfolio strategies that may result from the departure of a given partner. Often hedge fund manager principals (i.e., GP limited partners) specialize in certain asset types, strategies or market sectors, and thus the change in these sectors or investment approaches occasioned by a departing partner should be considered in the guidelines used for assessment of a payout to a departing partner. On the other hand, partners may feel that they have transferred their investment expertise to the management company – that it will remain an asset of the management company following their departure – and therefore they should be compensated for this intangible asset that they will leave behind. This would imply not only sticking with the current approach but building in a premium for the departing partner who leaves behind his or her expertise.

For example, a departing partner who has a market neutral arbitrage trading strategy will generate expected returns and risks that are much different from those of a partner who adheres to a stock-picking emerging markets trading strategy. Thus, it is not only the different types of assets that may require different valuation approaches but also the trading strategy itself.

Simplicity and Transparency

Fourth, simplicity and transparency may sometimes trump accuracy. These principles do not always work hand-in-hand. In some cases, sacrificing accuracy for intuition and simplicity may be preferred as long as there is no bias in the application of such techniques. This is because if a dispute arises and litigation is necessary, those deciding the final outcome will generally not be financial experts and must understand the intuition and intent of the guidelines. In that case, the simpler the better, and if accuracy is more complex and difficult to understand, it may not persuade the arbitrator, judge or jury.

How Will It Play Out in Court?

Fifth, consider what the courts will accept and find persuasive. While it is difficult to anticipate how the courts may react to disputes over valuation guidelines, some principles are clear:

- Lack of ambiguity reduces risk.
- Third-party independent verification when possible is preferable to subjective assumptions.
- Incorporating guidelines promulgated by regulators or other authoritative third parties (e.g., FASB, the SEC) is preferable to ad hoc assumptions.
- Economic rigor and use of fundamental and scientific valuation principles should be the underlying basis for setting guidelines, but should not make these guidelines overly complex.

All of the Above

Finally, it is sometimes necessary to take an “all of the above” approach. A weighted average of alternative approaches, along with guidelines on model parameters, third-party verification, and a suggestion on how the parties may come

to agreement (for example, via arbitration) is sometimes the best way to resolve potential disputes. This approach to setting guidelines encompasses all contingencies and lays out a framework for resolving any disputes that may arise.

The case studies that follow illustrate this.

Case Studies

Two different hedge fund general partnerships were similar in most respects, but had dramatically different guidelines regarding the way GP limited partners would be paid out upon departure.

Both had partners who wanted to leave the partnership and obtain their proportioned partner ownership interests. However, the costs involved in these departures were radically dissimilar.

In case one, the LLC had no clear guidelines on valuation. Only proportioned interests and an earnout period were specified. Ultimately, valuations were performed using the income approach, with three alternative assumptions applied to expected returns and discount factors. Peer comparables were also used, based on limited data on transactions and publicly traded asset management companies. These two different approaches, each containing three alternative assumptions, yielded six potential valuations. The difference between the highest and the lowest was over \$500 million.

Obviously the departing partner wanted the highest valuation and the remaining partners wanting the lowest. Litigation is still ongoing, and investors have lost faith in the fund’s investment strategy, along with the way it estimates NAV. The fund has frozen investor redemptions and is now facing additional potential litigation from shareholders – all because of the lack of guidance on valuation of interests of departing GP limited partners.

In case two, circumstances were identical except that the partnership established clear guidelines that specified how proportioned partner ownership interests of departing GP limited partners would be valued. The guidelines based valuation on proportional ownership along with:

- A combination of peer comparables and discounted cash flows, each with a specific weight to be used in determining the weighted average valuation – that is, one valuation that combined all the alternative approaches using alternative weighting schemes, all of which were agreed upon a priori.
- Specifications concerning the weight that would be placed on each valuation method in determining the weighted average valuation conclusion.
- Specifications concerning the range of parameter assumptions and type of peers that would be used for the valuation of the partnership.
- The identification of alternative third-party valuation and CPA firms that could be used to verify the calculations.
- A method of dealing with disagreements associated with partnership redemption interest, including arbitration.

This approach yielded one valuation where all parties agreed upon the underlying assumptions and the weights placed on each valuation method prior to entering into the agreement. It should be noted that this one valuation incorporated most of the techniques discussed above in a weighted average to yield one number. The result was a very smooth transition and a general partner redemption that did not lead to litigation or investor concerns.

Conclusion

The nature of hedge funds makes valuation of GP limited partner shares complex and ambiguous. One must foresee these ambiguities in crafting a general partnership breakup agreement that will lead to an orderly departure of GP limited partners, as opposed to a drawn-out litigation that could have huge costs.

Guidelines for the valuation of investments – a fundamental input into the valuation of the general partnership – must be linked to the assets in which the fund invests and the fund's investment strategy. Such guidelines are necessary for any breakup agreement.

Failure to consider these factors in crafting partnership valuation guidelines for departures of GP limited partners will lead to high litigation costs and even higher costs to reputation – with a consequent impact on the financial health of the fund management company. The right way to take all the complexities of the situation into account is to craft a partnership agreement that specifies how valuations will be determined, ideally leading to a single valuation that reflects the assumptions and expectations of the GP limited partners.

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