RECIPE FOR A HEDGE FUND LITIGATION NIGHTMARE:

MIX ILLIQUID ESOTERIC INVESTMENTS WITH AMBIGUOUS GENERAL PARTNER DISTRIBUTION RIGHTS

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Introduction

The hedge fund arena is notoriously challenging for all participants- general partners, investors, regulators and courts. The challenges are the result of the nature of hedge funds, which often operate in uncharted territory. Hedge fund assets can be esoteric, often illiquid, and are almost always extremely difficult to value. The result is that, when a hedge fund faces general partner separation difficulties, the difficulties are compounded by the complexities inherent in the hedge fund itself. This is particularly the case in any situation that requires an accurate valuation of the fund's assets.

A case in point is the breakup of a fund's management company or general partnership. 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 the exiting general partner, and estimating the impact on investors, requires an accurate valuation of the fund's current assets and a reliable estimate of its future performance. This is 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. This combination of illiquid investments, ambiguous general partner distribution or redemption rights, and unclear valuation methodologies is a perfect recipe for litigation. As many of us recognize, such litigation is especially costly to hedge funds. It may lead to disruption in 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. This article will address how to arrive at them.

Hedge Fund Asset Valuations, General Partner Shares, and Breakup Agreements

Let us begin with an overview of hedge fund valuation in the context of a breakup, and a look at why the valuation is so difficult to determine.

Hedge fund investments are managed by the general partners who typically form a general partnership Limited Liability Company (LLC). The value of that LLC, as with any other entity, depends on the expected future cash flows this partnership will generate.

The general partners share in the value of this partnership. Their participation is based on the management and performance fees that they will generate for the fund. Terms can vary, but the typical arrangement is 1% to 2% of the value of assets under management, and 20% of profits above a certain benchmark.

As to the value of those assets, the value of individual partner shares in the hedge fund will depend on the specified earnout (that is, the amount each period that a general partner is entitled to under the partnership agreement - this may also include the number of periods this amount is accrued upon a departure of a general partner), the expected management fee and the expected performance fee earned by the general partnership.

The management fee is determined by the total value of the assets held by the fund (the net asset value or NAV). The performance fee is determined by the returns that the partners are able to generate. Therefore, the valuation of each managing partner's share in the LLC 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 general partner makes the situation more difficult still. With the exit of a general partner, the distribution of that partner's share must be determined based on both historical capital that the partner may have invested in the LLC (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 partnership break-up agreement.

Different Methods, Different Results – and the Probability of Litigation Increases

The nature of hedge fund holdings and the absence of third-party trading value not only result in difficulty in measuring their value, but also lead to potentially widely disparate opinions on what the fund value and change in value might be.

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, say, 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. One needs to apply 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.

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 publicly available data upon which to draw such conclusions – something that almost by definition does not exist for hedge funds that function in the non-public sector. In the rare cases where it does, it's 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.

Finally, for option- and derivative-type 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 holdings and partnership LLC.

All of these challenges lead to one conclusion: *It is necessary to foresee the ambiguities in the valuation of managing partner shares and develop guidelines for the valuation of such shares to be used in breakup agreements.* 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 shares (the percent or proportion of ownership that each general partner owns in the partnership - the sum of all proportionate shares should equal 100%) and earnout period at redemption. But the agreements can often be ambiguous about how to determine the value of the partner earnout, 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 partnership itself or the impact of a partner's departure on future strategies and therefore on future performance.

In cases where the agreements specify the proportioned share of the LLC that belongs to each partner but leave no guidance as to how the partnership itself or the earnout will be valued, there can be very costly consequences when breakups occur. Absent unambiguous guidelines to determine how partnership shares should be redeemed, 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 shares is left in the hands of the court.

The alternative is to create guidelines for the valuation of the assets 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.

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 guidelines that are agreed upon by general partners prior to the formation of the 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.

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, we can categorize into four general types of investments: Fixed claims, residual claims, derivatives, and currencies/commodities.

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 appropriately. 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.

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 partners specialize in certain asset types, strategies, or market sectors, and thus the change in these sectors or investment approaches should be considered in the guidelines used for assessment of a payout for a partner who will depart. On the other hand, partners may feel that they have transferred their investment strategy expertise to the fund, that it will exist after they depart, 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 to the partnership.

For example, a departing partner who has a market neutral arbitrage trading strategy will generate expected returns and risks that are much different from that 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.

Fourth, *simplicity and transparency may sometimes trump accuracy* – these principles don't 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 or quant jocks and they 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.

Fifth, *consider what the courts will accept*. 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 always preferable to subjective assumptions.
- Regulatory (GAAP, SEC) verification, that is, using regulatory guidelines, is always preferred 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.

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 (i.e., arbitration) is sometimes the best way to resolve potential disputes. This approach to setting guidelines encompasses all contingencies and lays down a framework for resolving any disputes that may arise. The case studies that follow illustrate this.

Case Studies

Two different General Partnership LLC's were similar in most respects, but had dramatically different guidelines regarding the way LLC partners would be paid out upon departure.

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

In case one, the LLC had no clear guidelines on valuation. Only proportioned shares 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 had to put a hold on investor redemptions and is now facing additional potential litigation from shareholders – all because of the lack of guidance on valuations.

In case two, circumstances were identical except that the partnership established clear guidelines that specified how earnouts and departing partner redemptions 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 amount of 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 shares 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 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 general partners, as opposed to a drawn-out litigation that could have huge costs. This is especially the case as investors depend on the general partners to value their investments to determine the fees that they pay and the overall value of their portfolio.

Guidelines for the valuation of investments (and thus for the valuation of the general partnership) must be linked to the investment type and investment strategy. Such guidelines are necessary for any breakup agreement.

Failure to consider these factors in crafting partnership valuation guidelines for partner share redemptions will lead to high litigation costs and even higher costs to reputation – with a consequent impact on the financial health of the fund. 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 arrived at, leaving nothing to chance, and laying the groundwork for smooth, orderly transitions that meet the needs of departing partners, remaining partners, and investors alike.

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