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Private Equity Valuations: Standards and Recent Developments

By Brett D. Jaffe and Oliver S. Haker – August 16, 2012

It has been widely reported that in late 2011, several leading private equity funds received informal inquiry letters from the Division of Enforcement of the Securities and Exchange Commission (SEC). G. Zuckerman, “SEC Launches Inquiry Aimed at Private Equity,” *Wall St. J.*, Feb. 11, 2012; P. Lattman, “Private Equity Industry Attracts S.E.C. Scrutiny,” *N.Y. Times*, Feb. 12, 2012. Although these informal inquiry letters were broad in their scope (as is often the case in such inquiries), the SEC staff is understood to have requested production of documents concerning the valuation of private equity fund assets, the manner in which those valuations are reported, and details of agreements between the private equity fund and third-party valuation service providers. Such requests suggest a concern among regulators about the manner in which the funds that comprise the \$1.2 trillion private equity industry value their investments and present performance data to current and prospective investors. In light of the SEC’s focus on private equity valuation, as well as a number of private civil litigations directed to the issue, it is worth considering the standards governing the valuation of private equity assets and recent developments in the law on those valuations.

Valuation of any portfolio asset—private equity or otherwise—begins with the concept of fair value. Statement of Financial Accounting Standards (SFAS) 157 (now known as Accounting Standards Codification (ASC) 820) defined and established a framework for measuring fair value under United States Generally Accepted Accounting Principles, or GAAP. “Fair value” is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” SFAS 157, ¶ 5 (also known as ASC 820 in the updated Financial Accounting Standards Board codification). In the context of highly liquid, publicly traded securities (such as equities trading on a national securities exchange), fair value is relatively easy to calculate: It is typically the current trading price of the security, multiplied by the size of the portfolio position. However, in the context of private equity investments, calculation of fair value is far more complex. Without a liquid market to determine a prevailing market valuation, private equity fund managers must exercise discretion in determining a valuation methodology that will properly reflect the fair value of their investment. Such methodologies include reliance on valuation implied by the company’s most recent financing round, analysis of comparable companies, discounted cash flow analysis, and valuation predicated on the company’s net asset value. The private equity fund manager’s job is further complicated by the fact that no one of these methodologies may be sufficient to calculate

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a portfolio position's fair value. As has frequently been recognized, the "more illiquid the investment, the greater the need exists to use multiple valuation techniques to arrive at fair value." Rothstein Kass, *Fair Value Measurements and Disclosures: Best Practices for Implementation and Compliance for the Alternative Investment Industry—2010 Update*.

Critically, however, courts have recognized that the private equity fund manager's proper and reasonable exercise of discretion in determining fair value may protect the fund and its managers from private claims challenging the valuation of private equity assets. In a notable July 2011 decision, the United States District Court for the Southern District of New York addressed this issue in the context of the wide-ranging litigation related to the collapse of Lehman Brothers. *In re Lehman Bros. Secs. & ERISA Lit.*, 799 F. Supp. 2d 258, 311 (S.D.N.Y. 2011). In *Lehman Brothers*, pension funds and other investors claimed that Lehman's offering materials for various Lehman debt and equity securities contained material misstatements and omissions. Specifically, the plaintiffs alleged that Lehman's offering materials were false and misleading because they represented that Lehman's "private equity investments are measured at fair value" and that the offering materials expressly noted that Lehman had adopted SFAS 157 for determining "fair value." The plaintiffs alleged Lehman's valuation model made unreasonable assumptions and failed to consider certain market information in determining the fair value of Lehman's investment. Among other things, Lehman allegedly assumed a rental growth rate 1.9 to 3.5 percent higher than that projected by third parties and real estate investment trust (REIT) net operating income growth rates that were higher than the historical average. Lehman also allegedly failed to consider capitalization rates of other publicly traded REITs and used models that assumed real estate collateral would appreciate even as real estate prices were declining. Accordingly, the plaintiffs alleged, the valuation of the assets generated by Lehman's model did not truly reflect their "fair value," rendering Lehman's offering materials false and misleading. *Id.* at 311–12.

The court granted Lehman's motion to dismiss these claims, recognizing that

allegations that Lehman's valuation models were based on assumptions or inputs different than those used by third parties . . . or those plaintiffs would have used, is not sufficient to state a claim that Lehman's valuation methods did not comply with SFAS's fair value requirements or that the valuation statements based on those models otherwise were misleading.

Id. at 312.

The court emphasized that SFAS 157 expressly contemplated that different models, based on different assumptions, could be used to determine fair value; therefore, Lehman's "decision to use certain inputs and assumptions rather than others [was] consistent with SFAS 157." *Id.* Moreover, the court recognized the central roles that discretion and judgment play in the valuation of private equity investments, holding that "Lehman's determination that certain models, assumptions, and inputs were likely to provide accurate estimations of fair value was a matter of judgment." *Id.* The court noted that the values assigned by Lehman were "not statements of objective fact but instead reflect Lehman's judgment or opinion" and would thus

be actionable only if the plaintiffs had alleged that Lehman did not truly believe those valuations at the time they were issued. *Id.* at 313.

While the *Lehman Brothers* court protected good-faith efforts to provide fair valuations of private equity assets, fund managers who make unreasonable assumptions in the face of clear contrary indications of fair value still risk significant exposure to regulators and private litigants. In one notable example, in October 2011, Oppenheimer Holdings Inc. received requests from the SEC and the Attorney General of Massachusetts for information concerning the valuation of a portfolio holding in one of its private equity funds. D. McLaughlin & C. Stein, “U.S. Attorney Probing Oppenheimer Holdings on Fund Valuation,” *Bloomberg News* (Mar. 13, 2012). Subsequently, in February 2012, the U.S. Attorney’s Office for the District of Massachusetts notified Oppenheimer that it is investigating the same matter.

Oppenheimer Holdings Inc.’s 2011 10-K disclosed that it has been responding to information requests from the SEC and the Attorney General of Massachusetts since October 2011 related to “an alleged overvaluation in the fall of 2009 of a single portfolio holding in the Oppenheimer Global Resource Private Equity Fund L.P.,” as well as certain marketing practices associated with the fund during that same period. It further disclosed that the notice received from the U.S. Attorney’s Office for Massachusetts in February 2012 disclosed that the office intended to seek information from Oppenheimer regarding the same matters.

According to press reports, these regulatory investigations concern valuations employed by Oppenheimer’s Global Reserve Private Equity Fund I (OGR Fund). The OGR Fund invested in Cartesian Investors A LP, itself a closed-end fund holding a single asset: an investment in a publicly traded Romanian entity named S.C. Fondul Propriestatea SA. G. Zuckerman, “Private-Equity Fund in Valuation Inquiry,” *Wall St. J.*, Feb. 24, 2012. In documents shared with investors at the end of the second quarter of 2009, Oppenheimer valued its Cartesian investment assuming a value of 33 cents per share for S.C. Fondul. *Id.* However, on that same date, S.C. Fondul was publicly trading at just 7 cents per share on the Romanian stock exchange, and Cartesian Capital itself placed a value of only about 20 cents per share on S.C. Fondul. *Id.* In a move that drew scrutiny from regulators, Oppenheimer valued the investment at \$9.3 million—approximately \$7.3 million more than the public trading price for the underlying security itself. *Id.*

As is frequently the case, private litigants have filed suit on the heels of these regulatory inquiries. In March 2012, a securities class action suit was brought against various Oppenheimer entities and individuals, including the OGR Fund, in connection with the fund’s valuation of Cartesian Capital and the underlying S.C. Fondul asset. *See Brockton Ret. Bd. v. Oppenheimer Global Res. Private Equity Fund I, L.P., Oppenheimer Asset Mgmt., Inc., Oppenheimer Alt. Inv. Mgmt., LLC, Oppenheimer & Co. Inc., Brian Williamson & Patrick Kane*, Case No. 1:12-cv-10552-RWZ (D. Mass. Mar. 26, 2012). The complaint asserts that the OGR Fund’s private placement memorandum contained materially misleading statements concerning the purported value of the fund’s holdings, the profitability and performance of the fund, and the policies and

procedures used by the fund in conducting due diligence into the performance and valuation of its assets.

Tracking the regulatory inquiries, the complaint alleges the OGR Fund achieved its stated internal rate of return of 38.3 percent only by improperly valuing its investment in S.C. Fondul at 33 cents per share, a sharp departure from the 7 cents per share price then prevailing on the Romanian stock exchange. The plaintiffs point to the text of SFAS 157, which notes that, in most contexts, “quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.” Oppenheimer’s valuation of the fund asset at a multiple of that trading price is, according to the complaint, an improper application of SFAS 157’s fair value standard. Unlike the plaintiffs in *Lehman Brothers*, the *Oppenheimer* plaintiffs appear able to identify a generally accepted and accurate market methodology (public stock price) by which their assets could have been valued but for Oppenheimer’s alleged refusal to utilize it.

It is not yet clear how the SEC’s broad-based inquiry into private equity valuations will affect fund managers’ current valuation practices. One possible consequence of the current SEC investigation of the industry may be to require greater disclosure by the funds of the methodologies, assumptions, and models used to value their holdings. Although this increased transparency would be welcomed by investors (many of which are pension funds and other entities with reporting requirements of their own), it could also generate increased private litigation directed to private equity funds and fund managers. As investors become equipped with more information concerning various valuation methodologies, they can better detect if and when a fund deviates from its stated valuation methodologies and assumptions, as alleged in *Oppenheimer*. But, for the fund manager, increased regulatory scrutiny and the threat of private litigation will almost certainly force a reconsideration of valuation methodologies and assumptions. Managers may well be wise to invest the time and resources necessary to examine these issues now, before forced to do so by regulators or in the context of potentially devastating private securities litigation.

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