MANAGING AND VALUING HARD TO VALUE ASSETS: A LEGAL PERSPECTIVE

ANDRÉ ZERAFA, OF GANADO ADVOCATES, EXAMINES THE MANAGEMENT AND VALUATION OF HARD TO VALUE ASSETS FROM A LEGAL PERSPECTIVE

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Managers of alternative asset classes have several challenges ahead of them when launching a new fund or in their day to day management of asset classes such as private equity, venture capital, real estate or distressed debt to mention a few. Most of these challenges would typically relate to segregation and independence of the manager's key functions, namely portfolio management, risk management, compliance, valuation and remuneration.

In our experience, the manager's valuation obligations are probably one of the least understood and most problematic areas which managers have to grapple with as part of their daily operations.

The focus on valuation (of the fund's assets) was introduced by the Alternative Investment Management Directive (AIFMD). Prior to the introduction of the AIFMD, life was certainly more straightforward for the manager who was more concerned with their portfolio management functions than worrying about the valuation of the assets. The valuation of the assets would typically be a responsibility of the board of the fund or of the general partner and completed in accordance with the general principles reflected in the fund's offering documentation.

The AIFMD places responsibility for valuation of the fund's assets squarely at the feet of the manager and does not mention, nor does it consider, the role which is played by the fund's administrator or, even more importantly, by the fund's board of directors or general partner, depending on the fund's structure. The AIFMD also allows the manager to delegate the valuation function to an external valuation agent, subject to such third party fulfilling certain conditions. Nevertheless, responsibility for valuation remains with the manager even if this function is delegated to third parties, and it is therefore important for the manager to still have at least one key officer who is responsible for supervising the external valuer.

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It is unclear whether such responsibility for valuation would be towards the fund (assuming this has separate legal personality) or towards investors in the fund or whether this is purely a regulatory obligation. In other words, is the AIFMD creating a contractual obligation of the manager on the basis of which someone – investor or fund – could sue the manager or is it requiring managers to take on this responsibility and in default be responsible for breach of regulations by their supervisory authority? In article 19(10) the AIFMD does make reference to both fund and investor. "This article provides that the AIFM's liability towards the AIF and its investors, shall, therefore, not be affected by the fact that the AIFM has appointed an external valuer." This provision falls short of establishing what form and type of liability the AIFM would have towards the fund and investors, presumably leaving it up to each Member State to establish liability according to its private law.

In any event, contractual liability can only arise from contract which is typically between the fund and the manager and to which investors are not a party. Interestingly, the AIFMD does not contain any provision requiring the manager to reflect such a responsibility [for valuation of assets] in the management agreement. However, it is only the management agreement which can give rise to claims in contract.

The breach of any law or regulation can still give rise to tortuous claims; unless '(non-) breach of law' is reflected as a warranty in the management agreement so breach of such warranty would give rise to a contractual claim. It is beyond the scope of this article to explain the differences between a claim based in contract and one based in tort and it would suffice to say that a claim based in tort is harder to prove and is typ-

ically also subject to shorter prescriptive periods within which the claim can be brought forth. In several jurisdictions – particularly the Anglo-Saxon ones – there would also be the concept of fiduciary obligations which the manager has towards investors and on the basis of which the manager would be directly responsible towards investors without the need to establish a contractual link.

Over the last three years, we have seen an increase in private equity, venture capital, real estate and distressed-debt strategies. All these strategies have given rise to issues on valuation. Albeit in case of private equity and venture capital strategies where the fund controls the target then it would, more often than not, impose onto the target the same financial reporting and audit requirements which the fund itself has towards investors, sometimes also requiring the target to appoint the same audit firm in order to facilitate consolidation and valuation. This makes life easier for the manager, although regulators would probably expect the manager to review and question the valuation of the target as provided by the auditors since the manager would still be required to assume responsibility for such a valuation. In such a scenario, it would not even be possible for the manager to obtain indemnities from the auditors as these have no link with, nor responsibility towards, the manager.

We have also come across several situations where audit firms and administrators were not willing to act as external valuation agents for the purposes of the AIFMD. Indeed, some audit firms and administrators are willing and able to provide valuation support services to the manager (particularly in case of private equity, venture capital, distressed debt and structured investments) but very few are willing to act as external valuation agents. On the other hand, we have encountered several issues in case of real estate strategies where valuations could vary widely for the same property and where valuations provided by architects or real estate agents and brokers might not reflect market realities. The issues around valuation are expected to become more complicated with the onset of cryptocurrency funds and funds investing in other forms of crypto-assets.

We strongly believe that management of hard to value assets should only be undertaken by managers who understand the particular market intrinsically and have put together a team with a depth and breadth of experience who understand the business of the private equity or venture capital target or the geographical market of the real estate investment, and who are particularly strong on the valuation of assets. Specialisation is a key consideration and a manager running parallel strategies in several hard to value asset classes should beware of their responsibilities, particularly for valuation.

This sounds obvious, but we have come across a number of cases where the manager was naively placing full reliance on valuations made by third parties without obtaining indemnification, or else mistakenly assuming that the primary responsibility for valuation of assets rests with the board of directors of the fund or, in some cases, with the administrator and his responsibility is secondary and ancillary to theirs. It would appear that such an approach is contrary to the obligations imposed by the AIFMD and the expectations of regulators. It is advisable for managers to refer to international valuation standards for the particular asset class and to adopt such standards while retaining a certain amount of discretion which, when exercised, would need to be documented and justified. It is only then that the manager can rightly argue that when valuing the fund's assets it acted with the diligence expected from someone in its position having the level of expertise to assume such functions.