



Valuation Committees in Venture Capital Limited Partnerships— A Thing of the Past?

Thank you for visiting www.BVResources.com and downloading this article.
Please note this article or report is copyrighted and cannot be reproduced
or distributed without written consent.

Please contact Business Valuation Resources, LLC
to inquire about permission to reprint.

Phone: (503) 291-7963 ext. 109
E-mail: permissions@BVResources.com

Copyright © 2008 Business Valuation Resources, LLC.
All rights reserved.
(503) 291-7963
www.BVResources.com

Valuation Committees in Venture Capital Limited Partnerships - A Thing of the Past?

by Carl E. Kaplan, retired partner at Fulbright & Jaworski L.L.P, 7/15/2008

For over 25 years, Valuation Committees have played a key part in the evaluation of portfolios in the typical venture capital limited partnership; indeed in many partnerships it values the individual portfolio companies.^[1] The recent adoption of FAS 157^[2] mandates valuation methodologies and valuation standards which differ, and in some cases, conflict with existing practice.^[3] The tasks now required to value each portfolio company will be beyond the practical ability of a Committee to perform. Without the correct process, a GAAP accounting opinion will not be obtained. Valuation "mistakes" could conceivably also give rise to Committee liability.^[4] This article argues that the Valuation Committee be abolished.

First, a short history lesson on limited partnerships. Until about 25 years ago the limited partnership laws of most jurisdictions gave full power to the general partner to carry out all aspects of business.^[5] Limited partner involvement (either intra-partnership or with third parties) could give rise to general partner liability.^[6] Attorneys would refuse to opine on whether any given interaction with the general partner would impact adversely on the limiteds; so no opinion, no limited partner involvement.

The new generation of limited partnership laws became the rule in the mid 1980s and early 1990s.^[7] These statutes allowed the limited partners to be involved in the internal affairs of the partnership.^[8] In negotiations over rights of limited partners dialogue, veto and control rights now were demanded and obtained. In the portfolio valuation area, it became common for the portfolio to be valued by the Committee.^[9] The Committee's task was eased, somewhat, by a consensus in the industry of guidelines to be followed.^[10] The guidelines covered, among other things, when to value at cost, when to mark up or mark down, and when to take "haircuts" for publicly traded stock. All involved knew and accepted the proposition that although GAAP standards always called for "fair value" valuations, the difficulties in valuing the illiquid securities held in venture capital portfolios could ease immeasurably by a guideline approach.

FAS 157 changes the process. It does not allow for an "easy" guideline technique. Each portfolio investment valuation must be made using financial valuation techniques at each reporting event and these valuations must be supported.^[11] Illiquid securities need a so-called "Level 3" analysis which utilizes methodologies and instruments requiring significant management judgment or estimation to determine fair value.^[12]

What this means is that a new set of practices will have to be employed. So, who should be responsible? It makes sense for the general partner to handle these matters, not the Committee. Consider the differences between a first-round year old research start-up and an established operation with sales and earnings and many rounds of financing. Each would presumably require different valuation procedures. In a typical venture capital set-up, the Committee has few resources, tools or time to handle the workload; the Committee is not analogous to an audit or compensation committee of a publicly traded company.^[13] It could also be argued that the Committee is not "independent".^[14] Further, the auditor will not be involved as an aide to the general partner in the valuation context for a variety of reasons. The auditor will either accept the valuations submitted or not.^[15]

The general partner has the tools to do the job and should be responsible, solely, for the valuations (the analysis would be similar to those used in valuing companies for investment).

All involved would agree that the valuation obligations under FAS 157 will be difficult to perform. It would be anticipated that all would agree that the present committee set up is not conducive to conducting the work necessary. It is also true that while liability to other limited partners or to third parties for mistaken or flawed monthly valuations may be theoretical, the valuation committee runs risks now that didn't exist prior to FAS 157. The reporting "buck" should stop at the general partner. Valuation Committees served a useful function as a "brake" on the general partner, in the new world it serves no function.^[16]

Carl E. Kaplan is a retired partner at the law firm of Fulbright & Jaworski L.L.P. Traci Tomaselli, an associate at Fulbright & Jaworski L.L. P., assisted in the preparation of this article.

^[11] A representative statement of the Committee's role reads:

"The Valuation Committee shall review and may revise each valuation made by the General Partner. The decision of the Valuation Committee as to the value of the assets shall be final, except as otherwise provided in this Limited Partnership Agreement."

^[21] FAS 157 was adopted by the Financial Accounting Standards Board in September 2006. FAS 157 is effective for fiscal years beginning after November 15, 2007, and all interim periods within those fiscal years. See Statement of Financial Accounting Standards No. 157 (Fin. Accounting Standards Bd. 2006).

^[31] This article assumes a basic familiarity with FAS 157 and is intended to address the FAS 157 situation as it applies to the typical venture capital limited partner fund. Private equity and buy-out firms have similar issues but given their size and types of investments they have

issues unique to their businesses. For an excellent overview of FAS 157 see Espen Robak, *Fair Value of Private Equity* (2008), http://vcexperts.com/files/encyclopedia/562/Pluris_FAS_157_Handbook.pdf.

^[4] Many might argue that the liability is more theoretical than real. However, it would not be difficult to conjure a fact pattern where negligence, gross negligence or even collusion with the general partner could be alleged.

^[5] Section 7 of the 1916 Uniform Limited Partnership Act provided that "A limited partner shall not become liable as a general partner unless . . . he takes part in the control of the business." Unif. Limited Partnership Act § 7 (1916). The 1976 Uniform Limited Partnership Act sought to deal with the difficulty in determining what constituted "control" and provided a list of activities which fell within a safe-harbor, however, the 1976 Uniform Limited Partnership Act continued to contain a provision which subjected a limited partner to general liability if "the limited partner's participation in the control of the business is . . . substantially the same as the exercise of the powers of a general partner." Unif. Limited Partnership Act § 303 (1976). The 1985 amendments to the 1976 Uniform Limited Partnership Act further amended Section 303 to increase the activities included in the safe-harbor and expressly provided that "if the limited partner participates in the control of the business, he is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." Unif. Limited Partnership Act § 303 (amended 1985).

^[6] *Id.*

^[7] The Delaware Revised Uniform Limited Partnership Act was enacted effective January 1, 1983, New York followed by enacting their Revised Limited Partnership Act in 1991.

^[8] Since the adoption of the Delaware Revised Uniform Limited Partnership Act a limited partner will not be liable for the liabilities or obligations of the partnership unless he is also a general partner or participates in the control of the business. Del. Revised Uniform Limited Partnership Act § 17-303(a). Section 17-303(b) of the Delaware Revised Uniform Limited Partnership Act provides a safe-harbor for actions which may be taken by limited partners without being deemed to be in control of the business. *Id.* at § 17-303(b).

^[9] See Michael Halloran, Lee F. Benton et. al., *Venture Capital & Public Offering Negotiation* 1-152, (Aspen Publishers 2007).

^[10] See NVCA.org, The National Venture Capital Portfolio Company Valuation Guidelines, http://www.nvca.org/val_guidelines.html ; see also PrivateEquityValuation.com, The

International Private Equity and Venture Capital Valuation Guidelines, [International PE VC Valuation Guidelines Oct2006.pdf](#). The International Private Equity and Venture Capital Valuation Guidelines have been endorsed by 21 European and Non-European Associations. *Id.* at 1.

^[11] See Roger Mulvihill, *Fair Value Reporting for Illiquid Investments: Ready or Not (Here it Comes)*, (2007),

<http://www.altassets.com/knowledgebank/learningcurve/2007/nz12279.php>.

^[12] See Statement of Financial Accounting Standards No. 157, *supra* note 3 at paragraphs 21-30.

^[13] Rule 10A-3(b)(4) of the Securities Exchange Act Rules requires that the Audit Committee have authority to engage independent counsel and other advisers. Compensation Committees are generally given the authority to engage compensation consultants and similar advisers. Securities Exchange Act Rule 10A-3(b)(4).

^[14] Members of valuation committees are often determined by both the general partner and certain limited partners. See Halloran, *supra* note 10 at 1-157-8.

^[15] Auditors would compromise their independence if they became involved in valuation calculations although they could assist with setting up processes and procedures for conducting a valuation. See Wanching Leong, "Damned if You Don't", in *The 2007 PEI Manager Yearbook* 39; see also Joseph W. Bartlett, "Red Alert for Buyout and Venture Funds: Fair Value Measurements adopted by the Financial Accounting Standards Board on September 2006 ("FAS 157")", (2008),

http://vcexperts.com/vce/news/buzz/archive_view.asp?print=true&id=555.

^[16] Presumably, to abolish the valuation committee would have to be an amendment to the limited partnership agreement; individual valuation committee members could also resign.