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Caught Red-Handed—"Untitled (Gopi)" (21.1 in. by 16.1 in.) by Jamini Roy sold for $12,500 at Sotheby's Modern & Contemporary South Asian Art Sale in New York on Sept. 10, 2012, p. 4.

INSIDE: 2012 CHARITABLE GIVING SUPPLEMENT

SPECIAL REPORT:
VALUATIONS

By **J. Wesley Pennington III** & **Brian P. Holloway**

The Gate Clause

Does it warrant a valuation adjustment?

A gate clause (also called a "lock-up" provision) is a little-known and lesser-used codicil to some hedge fund governing documents,[1] designed to limit investor withdrawals and, thus, avoid a "run on the bank." Many investment funds are designed with a long-term hold strategy, making the investment illiquid. To incentivize investors and provide liquidity, some funds offer a redemption privilege, effectively creating a market. As a countermeasure to extreme market conditions, however, many funds incorporate gate clauses into their governing documents (for example, a placement memorandum or prospectus).[2]

While gate clauses may exist in any fund, gates are most typically seen in funds in which the target investment's lack of liquidity or volatility makes this feature desirable to the fund manager. For example, an investment in exchange-traded securities probably wouldn't have a gate clause, while an investment in bankruptcy claims would be likely to have one.

When valuing a decedent's interest in a hedge fund investment, practitioners may be tempted to use the reported net asset value (NAV).[3] At first glance, reported NAV seems to eliminate the need for an appraisal and, to the extent the investment interest is redeemable by the fund, to eliminate the need for a discount for lack of marketability (DLOM). However, if the fund has a gate clause limiting redemptions in volatile market conditions, we believe the NAV may require a valuation adjustment to reflect fair market value (FMV)[4] of the interest in the investment.

Type of Withdrawal Request

Gate clauses may affect aggregate withdrawal requests (a fund level gate) or an individual investor's withdrawals (an investor level gate).

Example: Assume a fund level gate of 20 percent. The maximum withdrawals allowed in a given period (typically, a calendar year quarter) will be capped at 20 percent of the fund's aggregate NAV. If aggregate investor requested redemptions exceed 20 percent, then all redemption requests will be reduced pro rata to the 20 percent cap.

An investor level gate may require the initial investment to be maintained for a specified period, then cap the individual withdrawal at a percentage of the initial investment.

A Blessing and a Curse

To fully understand the need for, and amount of, a valuation adjustment, you need to understand the impact of the gate on NAV. Intuitively, a restriction on withdrawal is a potential threat to liquidity.

However, a gate clause can impact the fund manager's need to forcibly liquidate some or all of the fund assets to satisfy withdrawal demands. That's an unexpected side effect—the gate can actually help the investor in the long run by minimizing forced liquidation decisions. "Stabilization of Demand," p. 63 illustrates this effect.

Valuation Adjustment

Armed with a basic understanding of gates, the next step is to determine whether a particular client's situation justifies a valuation adjustment. If so, what's the amount of appropriate adjustment, and how should the adjustment be reflected?

We consider two possible scenarios: (1) a gated fund in which the gate hasn't been invoked, and (2) a similar fund, but with the gating restrictions currently imposed. For purposes of this article, we'll refer to these scenarios as a "passive gate" and an "imposed gate," respectively.

Passive gate. We believe a gated fund merits careful


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analysis for the applicability of a valuation adjustment. In addressing this question, the appraiser might ask: "What is the probability of the gate being invoked at the time of withdrawal?" This question, in turn, might consider:

- Nature of the fund assets (volatility, liquidity);
- Nature of the market in which the underlying asset can be sold; and
- Current or forecasted macroeconomic conditions.

If an adjustment is merited, we believe that a valuation adjustment for a passive gate is best reflected through a DLOM.[5] The theoretical underpinnings of a DLOM are derived from two sources: (1) empirical research, and (2) theoretical models.[6] Empirical research results are broadly derived from restricted stock studies, whereas theoretical models draw their results from option pricing models.[7] Thus, the underlying asset will have an impact on the weighting of these results.

While the selection of the appropriate DLOM is up to the analyst, a fund with a passive gate (as we defined it) intuitively appears to fall at the lower end of the discount range.

Imposed gate. While infrequent in occurrence, an imposed gate creates a far greater risk of realizing the current NAV at its stated value. The analyst can readily predict neither: (1) future NAV, nor (2) timing of the withdrawal. Thus, we find that an imposed gate probably merits use of a predictive model, rather than a DLOM.

We believe that an option pricing model is the preferred approach to derive FMV. Key inputs to option pricing models are price volatility and holding period, which are the two uncertainties in our gate fund example and, thus, appear to form a supportable base for defending its use. Again, the appropriate model and value are the appraiser's choice.

Stabilization of Demand

The gate can help minimize forced liquidation decisions

— J. Wesley Pennington III & Brian P. Holloway

IRS and Tax Court

We're unaware of any Internal Revenue Service private letter rulings or Tax Court cases adjudicating a valuation adjustment solely attributable to a gate clause in an investment fund. The prevailing position of the IRS[8] and courts[9] is to accept DLOMs for close corporation stock and certain other assets with limited marketability on a case-by-case basis. Thus, we believe that, if challenged, a well thought-out and documented position will improve the chances of prevailing.

Endnotes

1. We use hedge funds throughout this article as an example of an investment with a contractual gate clause. However, similar contractual restrictions may apply to venture capital funds, private equity funds or any investment vehicle with redemption and gate features.
2. Note that original documents may be subsequently changed by majority vote, so, if this issue is critical, the appraiser should confirm with the investment manager whether amendments to the original documents have occurred.
3. This article applies to funds that allow the investee to redeem the investment directly with the fund. Implicit in the gating clause concept is a contractual redemption privilege by the fund; for example, a de facto buy-sell agreement or an investor "put" to the fund. We presume that, absent a gating clause, a redemption privilege negates the need for a discount for lack of marketability (DLOM).
4. We assumed fair market value is the appropriate standard of value, although the concepts presented herein may be appropriate when other standards of value apply.
5. We recognize that other methods may be appropriate, depending upon the situation.
6. Robert Reilly and Aaron Rotkowski, "The Discount for Lack of Marketability: Update on Current Studies and Analysis of Current Controversies," *Tax Lawyer,* Vol. 61, No. 1.
7. Such as those models described in the AICPA Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation.*
8. Discount for Lack of Marketability, Job Aid for IRS Valuation Professionals, Sept. 25, 2009, *www.irs.gov/pub/irs-utl/dlom.pdf.*
9. Numerous court cases allow a DLOM.