PRIVATE EQUITY AND NET ASSET VALUE DEBT – TICKING TIME BOMB OR TICKING ALL THE RIGHT BOXES?

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The private equity leveraged buyout (LBO) industry has been on the ropes in recent years, with high interest rates making acquisitions more costly, severely depressing exit values, and hampering fund-raisings. Accordingly, the industry has sought to adapt, and net asset value debt (NAV Debt) has come to the fore extolled in some quarters as being the savior of the industry. NAV Debt is borrowing by a fund backed-up by the net asset value of all the portfolio companies that it owns. NAV Debt cuts against the grain of conventional LBO mechanics by creating liabilities at the fund-level rather than at the level of individual portfolio companies. In this article, the traditional LBO model and the governance advantages that emerge therefrom are described, before discussing the way in which NAV Debt challenges the customary form. The article argues that although NAV Debt is versatile in its uses and conceptually can provide benefits to a private equity fund, it also has a darker side that undermines the carefully curated dynamics of the LBO archetype and could in certain circumstances be detrimental to LBO investors. Lenders and fund sponsors may claim that NAV Debt ticks all the right boxes, especially during a period of economic turmoil, but, in fact, its use bakes-in significant risks that could pummel final returns. Although NAV Debt is perhaps not quite a ticking time bomb, it could represent a gamble that tarnishes the returns of a generation of funds.

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INTRODUCTION

"Private equity" is the routine answer to the bar trivia question "who shot Geoffrey the Giraffe?", the mascot synonymous with erstwhile toy store Toys "R" Us. Toys "R" Us embodies both the perils of private equity and the robustness of the business model. Toy "R" Us was infamously the subject of a 2005 $6.6 billion leveraged buyout (LBO) by a consortium of private equity firms – KKR, Bain Capital and Vornado.[1] 80% or $5.3 billion of the purchase price was provided by debt which was, after acquisition, loaded on to the company's books.[2] Under the sheer weight of $400 million of interest

[1] ELI TALMOR & FLORIN VASVARI, INTERNATIONAL PRIVATE EQUITY (2011).
[2] *Id.*

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per annum,[3] Toys "R" Us entered Chapter 11 bankruptcy in 2017, before succumbing to liquidation in 2018 and litigation that still haunts the original protagonists today.[4] 30,000 U.S. jobs were lost, lenders had to take a haircut on their loans, and unsecured creditors such as suppliers and landlords were $800 million out-of-pocket.[5] International losses were similar.[6] The funds sponsored by the private equity consortium lost $1.3 billion of investor contributions to those funds,[7] and, on its individual merits, Toys "R" Us was a disastrous investment and a catastrophe for a much-beloved company and its stakeholders.

The flipside to the Toys "R" Us debacle is that the fund's ownership of other companies was not impacted by its insolvency. For example, KKR Millennium Fund, the KKR-sponsored fund that invested in Toys "R" Us, also acquired household names Sunguard, HCA and Sealy. Even though the fund had notionally borrowed funds to acquire Toys R' Us, the lenders of the debt to acquire Toys "R" Us could not reach those other assets of the fund, and the fund was not forced to sell those companies to generate liquidity to satisfy the debts of Toys "R" Us. The traditional LBO model enables each portfolio company owned by a fund to continue to operate fully insulated from the distress of any other such portfolio company. In fact, notwithstanding KKR Millennium Fund's sizable loss on Toys "R" Us, overall, investors in the fund earned large positive returns,[8] with the positive performance of other portfolio companies outweighing the loss on Toys "R" Us. The conventional LBO model, albeit controversial, does not allow failed investments to contaminate the ownership of healthy companies. Circumstances have, however, changed – the LBO model still lives on, but, in many cases, not as we know it.

The double blow of a high interest rate environment and global economic uncertainty has led to the private equity industry experiencing dark times between 2022 and 2024. The extended period of historically low interest rates which propelled private equity activity and success to new heights is already a speck in the rear-view mirror. In the face of a hostile economy, though, private equity has sought to adapt, stress-testing the limits of the customary leveraged buyout (LBO) model through the embrace of majority equity-funded acquisitions, continuation funds, and direct lending from non-traditional sources. The latest strategy to explode upon the LBO scene is "net asset value debt" (NAV

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[3] Nathan Vardi, *The Big Investment Firms That Lost $1.3 Billion in the Toys "R" Us Bankruptcy*, FORBES (September 9, 2017) https://www.forbes.com/sites/nathanvardi/2017/09/19/the-big-investment-firms-that-lost-1-3-billion-on-the-toys-r-us-bankruptcy/

[4] Ben Unglesbee, *The Story of Toys R Us' Bankruptcy is Still Unfolding, and it Still Matters*, RETAILDIVE (January 20, 2022) https://www.retaildive.com/news/the-story-of-toys-r-us-bankruptcy-is-still-unfolding-and-it-still-matters/617429/

[5] *Id.*; Ben Unglesbee, *How Toys R Us' Bankruptcy Hopes Came Crashing Down*, RETAILDIVE (March 15, 2018) https://www.retaildive.com/news/how-toys-r-us-bankruptcy-hopes-came-crashing-down/519230/

[6] Alex Ralph, *Toys "R" Us Creditors £1.1bn Out of Pocket*, THE TIMES (May 2, 2018) https://www.thetimes.co.uk/article/toys-r-us-creditors-1-1bn-out-of-pocket-6tjnlglwq (noting unsecured creditor losses of £1.1 billion in the U.K.); Sarah Butler, *Toys "R" Us to Shut all UK Stores, Resulting in 3,000 Job Losses*, THE GUARDIAN (March 14, 2018) https://www.theguardian.com/business/2018/mar/14/toys-r-us-to-shut-all-uk-stores-resulting-in-3000-job-losses#:~:text=Toys%20R%20Us%20to%20shut,losses%20%7C%20Retail%20industry%20%7C%20The%20Guardian (noting 3,000 job losses in the U.K.).

[7] Vardi, *supra* note 3.

[8] For example, the private equity portfolio reports of three investors in KKR Millennium Fund each show internal rates of return of over 16% on the fund (Oregon Public Employees Retirement Fund, *Private Equity* Portfolio (March 31, 2023), at 4; Washington State Investment Board, *Private Equity Portfolio Overview by Strategy* (December 31, 2022), at 2-2; Minnesota State Board of Investment, *Comprehensive Quarterly Performance Report* (March 31, 2024), at 80).

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Debt) – the incurrence of debt at the level of the fund, backed-up by the value of portfolio companies owned by that fund. However, the rise of NAV Debt does not so much merely push the boundaries of the asset class but rather rips to shreds the standard rules of private equity.

The use of debt to acquire portfolio companies is a defining characteristic of private equity buyout funds. The incurrence of high levels of leverage to part-fund acquisitions can enhance returns on investment and is a critical factor in private equity's success. The basic model involves a private equity fund establishing a separate special purpose vehicle or vehicles (SPVs) to acquire each individual portfolio company. Debt funding for each acquisition is incurred by a SPV acting as a holding entity solely for that specific acquisition. Therefore, when a fund makes multiple acquisitions, debt obligations for each individual acquisition are siloed. If any portfolio company becomes distressed, a finance provider that has provided the acquisition debt for that investment is restricted to enforcing against the specific assets of that company. Importantly, with the traditional private equity business model, other than short-term subscription facilities to tide-over funds waiting for investors to satisfy drawdown requests, the fund itself avoids the incurrence of liabilities. Accordingly, any drawdowns from investors, exit proceeds to be distributed to investors, or fees to be allocated to the private equity firm held in the accounts of the fund are not encumbered by debt or other liabilities.

Taking a sledgehammer to the finely curated structuring of liabilities in the LBO model, NAV Debt essentially involves long-term debt financing at the fund-level. Either the fund itself incurs the debt, or an SPV established by the fund becomes the borrower with the fund guaranteeing repayment of the debt or entering into an equity commitment letter to finance the SPV's repayment obligations. The debt is borrowed against the net asset value of *all* the investments of the fund. The level of the debt will constitute a percentage of that net asset value, and lenders will likely require security over the assets of the fund in a manner that does not constitute a breach of any existing finance facilities underlying individual portfolio investments. Noting that the underlying assets are heavily leveraged themselves, NAV Debt has recently been excoriated as being "leverage-on-leverage".[9]

Although NAV Debt has been around for years,[10] its use-case and prevalence in the private equity buyout industry has expanded extraordinarily in recent times. Historically, NAV Debt was the preserve of credit, secondaries and infrastructure funds,[11] and, in particular, was common in the fund-of-funds sphere, where a fund would borrow against the value of its interests in other funds.[12] However, it was

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[9] Valerie Martinez, *Bank of England Official Raises Alarm Over Private Equity Use of NAV Loans as Exits Slow*, INVESTMENT WEEK (April 22, 2024) https://www.investmentweek.co.uk/news/4199872/bank-england-official-raises-alarm-private-equity-nav-loans-exits-slow (reporting a speech by a Bank of England official).

[10] Chris Witkowsky, *Continuation Funds, NAV Loans Potentially Disruptive of LP/GP Relationship: Goldman Survey*, BUYOUTS (September 27, 2023), available at https://www.buyoutsinsider.com/continuation-funds-nav-loans-potentially-disruptive-of-lp-gp-relationship-goldman-survey/#:~:text=NAV%20loans%2C%20which%20have%20been,%24100%20billion%2C%20Buyouts%20recently%20reported

[11] Darlen G. Leung & Amanda C. Balasubramanian, *NAV Fund Financing on the Rise for Private Equity*, TORYS QUARTERLY (Summer 2022).

[12] Meyer C. Dworkin & Samantha Hait, *The Continuing Evolution of NAV Facilities* in GLI FUND FINANCE 2019 (Michael C. Mascia, 3rd ed., 2019).

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rare for LBO funds to borrow against the value of the portfolio companies owned by the fund. To the extent that LBO funds did incur NAV Debt, it was usually new players in the market or smaller private equity sponsors owning distressed assets that did not have the reputation or scale to convince lenders to provide risky loans purely against the assets of individual investments.[13] In their desperation, borrowing at the fund-level, backed by the assets of all of the fund's investments was their only option for leverage and liquidity.

The onset of the pandemic saw NAV Debt hit the big time. No longer simply the sanctuary of panicked smaller players in the market, blue chip private equity sponsors began to utilize NAV Debt to fund investments due to a reluctance to call for capital from investors during macroeconomic uncertainty when deal closings were unpredictable.[14] The more recent economic shock of high interest rates which has hammered the LBO industry, causing leverage for acquisitions to become more costly, exits valuations to plummet, and a lack of investor liquidity to support new fund raises, has further drawn NAV Debt back to the mainstream.[15] Not only have household LBO names started entertaining NAV Debt, but the sums borrowed have been enormous. In recent years, funds sponsored by LBO behemoths Carlyle, Softbank, Vista Equity, HG Capital and Nordic Capital have sought to borrow NAV Debt amounting to $1 billion, $4 billion, $1.5 billion, $500 million and €600 million, respectively.[16] A partner of one of the most prolific NAV Debt lenders in Europe has noted that they have had numerous discussions relating to potential NAV Debt facilities of $1 billion or more.[17]

According to the Fund Finance Association, the 2023 global market for NAV Debt was approximately $100 billion,[18] with reports that the market had doubled within the previous two years.[19] Purveyors of NAV Debt have been buoyant on the prospects of the NAV Debt industry expanding in the coming years, with one lender predicting year-on-year growth of 30-50%,[20] with the market tripling as soon as 2025,[21] and reaching $600 or $700 billion by 2030.[22] As demand has expanded, so has supply, with a secondaries advisor noting that 30 new NAV Debt lenders had entered the market in the

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[13] Matthew K. Kerfoot & Jinyoung Joo, *Key Drivers Behind Widespread Adoption of NAV Financing*, PROSKAUER LAW 360 (August 24, 2023).
[14] Leon Stephenson and Bronwen Jones, *NAV Finance: Now and the Future*, PRIVATE EQUITY INTERNATIONAL (May 22, 2023) https://www.privateequityinternational.com/nav-finance-now-and-the-future/
[15] Kerfoot & Joo, *supra* note 13 (noting the rise of megacap sponsors seeking NAV Debt facilities in excess of $1 billion).
[16] Will Louch, Antoine Gara & Chris Flood, *Buyout Groups Raise Debt Against Portfolios to Return Cash as Dealmaking Slows*, FINANCIAL TIMES, July 18, 2023, available at https://www.ft.com/content/f23d9cd9-2650-4943-a9ac-eb262414e772
[17] Amy Carroll, *The Rise of NAV Lending*, BUYOUTS (June 1, 2023), available at https://www.buyoutsinsider.com/the-rise-of-nav-lending/ (quoting a partner from 17Capital).
[18] Sean Lightbrown, *The Rise of NAV Lending in Private Equity*, MOONFARE INSIGHTS (July 6, 2023) https://www.moonfare.com/blog/what-is-nav-lending; Selin Bucak, *Investors Question PE Funds' Use of NAV Loans and Capital Calls*, CITYWIRE (November 7, 2023).
[19] Stephenson & Jones, *supra* note 14.
[20] Alicia McElhaney, *Private Equity's Woes Spur Rise in NAV Loans – and Managers Offering Them*, INSTITUTIONAL INVESTOR (August 18, 2023) https://www.institutionalinvestor.com/article/2c2p0gk8pjstkz630fdvk/corner-office/private-equitys-woes-spur-rise-in-nav-loans-and-managers-offering-them
[21] Financier Worldwide Magazine, *Huge and Growing: The Rise of NAV Financing* (August 2023), https://www.financierworldwide.com/huge-and-growing-the-rise-of-nav-financing#:~:text=According%20to%2017Capital%2C%202022%20was,month%20period%20ending%20September%202022
[22] *Id.*; Lightbrown, *supra* note 18; Bucak, *supra* note 18.

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first quarter of 2023 alone.[23] Although those hubristically extolling the virtues of NAV Debt may have a self-interest in prophesying exponential future growth, the current rise in NAV Debt is very real. In the LBO realm, NAV Debt has evolved from being a last-ditch option for backwater operators into an established financial tool.

This is the first academic paper of any discipline to scrutinize the rising tide of NAV Debt incurrence by private equity LBO funds. In this paper, the reasons for the incurrence of NAV Debt in the current economic climate will be described, categorized into offensive, defensive and liquidity NAV Debt. Offensive NAV Debt is opportunistic and used to fund acquisitions, bolt-on investments and refinancings of individual portfolio investments. Defensive NAV Debt is reactionary and used to buttress underperforming assets with a view to rescuing and turning around struggling portfolio companies. Liquidity NAV Debt is neither opportunistic nor reactionary and does not relate to individual portfolio investments of the fund, but rather is used to make distributions to investors unusually detached from dividends or exit returns from underlying portfolio investments.

This papers outlines, for the first time, the conceptual and practical benefits and costs of NAV Debt. In terms of benefits, NAV Debt could be considered to be a rational and innovative adaptation to the current economy. Offensive NAV Debt, by being backed by a greater value of assets, can finance acquisitions at a lower cost than debt at the portfolio company-level, allowing funds to spy a bargain and take advantage of dislocated asset prices with a presumption that value will increase when interest rates decline. Offensive NAV Debt also enables funds to more cheaply refinance maturing acquisition debt. Defensive NAV Debt provides a source of rescue financing secured against the net asset value of all the fund's investments that lenders may not otherwise be prepared to provide if the only collateral were the distressed assets that the fund is seeking to turn around. Liquidity NAV Debt can potentially facilitate the traversal of periods of low valuations by providing investors with liquidity events without having to divest of investments at a bottom-of-market values or expose investors to the heavily discounted secondaries market. Accordingly, by making distributions to investors, those very same investors will have the capacity to support fund-raising for successor funds established by the same private equity sponsor. Lenders for their part view NAV Debt as an opportunity to derive fees from lending activity at a time when the market for private equity and corporate acquisitions has declined.

However, conceptual benefits could easily give way to real-world risks. This article presents four categories of threats which should give investors pause for thought when funds in which they invest incur or propose to incur NAV Debt. First, the cross-collateralization of assets precipitated by NAV Debt can lead to contagion risk. This article will describe how a fund that has incurred NAV Debt could be forced to divest of healthy assets to compensate for declining values elsewhere. Not only are returns from high-quality portfolio investments no longer insulated from poor investments, but the existence of NAV Debt with covenants that straddle the entire portfolio can subtly change the mindset of decision-

[23] Carroll, *supra* note 17.

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making at individual portfolio companies. Second, the urge to incur NAV Debt may be grounded in the extraction of private benefits by the general partner of the fund rather than benefits to the fund's investors. In certain circumstances, NAV Debt can accelerate the general partner's performance-based compensation – the carry – and possibly facilitate a larger overall management fee over the life of the fund. Third, NAV Debt creates several governance issues. The success of private equity has often been attributed to the governance benefits of the model over publicly-traded companies.[24] However, many of those governance advantages may be weakened by NAV Debt, including an inability to deduct NAV Debt interest payments from portfolio company profits for corporation tax purposes, a lengthening of holding periods of portfolio companies, debt providing less of a disciplining effect on portfolio company managers, and a possible expansion in LBO investments from the mature companies that form the bedrock of the traditional approach to riskier early-stage companies. Finally, NAV Debt creates the potential for financial manipulation, and introduces greater opacity to private equity remuneration and valuation mechanics at a time when the Securities and Exchange Commission (SEC) is seeking to improve transparency. NAV Debt can artificially enhance metrics which are used to judge general partner performance and calculate fees.

This article is organized as follows. In Part I, the traditional private equity model is described including fund structuring, private equity compensation, and the use of leverage. The "rules" of private equity are also outlined, noting that conventionally no debt or liabilities are incurred at the fund-level, and all portfolio investments are structured into individual silos. Part II discusses the basics of private equity governance at the fund- and portfolio company-levels, and the aspects of the model that are often cited as being important to the success of the LBO industry. It is argued that the traditional private equity business model is delicately balanced to ensure that risk is contained, agency costs are minimized, and conflicts of interest are mitigated with fund-sponsor and investor interests broadly aligned. In Part III, NAV Debt is described in detail, setting-out how it diverges from the usual LBO model, and how it is structured and secured. Part IV delineates the types of NAV Debt, characterised as offensive, defensive and liquidity, together with the rationales for its incurrence and the benefits that could accrue to the fund. Part V elucidates how NAV Debt ruptures the traditional LBO model described

[24] SIMON WITNEY, CORPORATE GOVERNANCE AND RESPONSIBLE INVESTMENT IN PRIVATE EQUITY, at 187 (2021). Empirical studies of private equity-backed company profits and operating performance generally trend in a positive direction. Earlier studies more conclusively showed private equity-backed company outperformance compared to publicly-traded companies (*e.g. Steven Kaplan, The Effects of Management Buyouts on Operating Performance and* Value, 24 J. FIN. ECON 217 (1989) (finding LBOs lead to increases in operating income and cash-flow, and a decrease in capex); Abbie J. Smith, *Corporate Ownership Structure and Performance*, 27 J. FIN. ECON. 143 (1990) (finding LBOs lead to increases in operating cash-flow)). However, newer studies are slightly more mixed (*e.g. Steven J. Davis et al, Private Equity, Jobs, and Productivity. 104 AMERICAN ECONOMIC REVIEW*, 3956 (2014) (finding LBOs result in gross job creation and increases in total factor productivity); Shourun Guo, Edith S. Hotchkiss & Weihing Song, *Do Buyouts (Still) Create Value?*, 66 J. FIN. 479 (2011) (finding LBO firm gains in operating performance that are either comparable to, or slightly exceed those of, benchmark firms); Daniel Rasmussen, *Private Equity: Overvalued and Overrated*, AM. AFF. (2018) (finding that 54% of LBOs resulted in slowing revenue growth and 45% resulted in contracting margins)). For a succinct overview of performance studies, *see* Peter Morris & Ludovic Phalippou, *Thirty Years After Jensen's Prediction: Is Private Equity a Superior Form of Ownership?*, 36 OX. REV. ECON. POL. 291, 299-302 (2020). Evidence (particularly more recent evidence) is not conclusive as to whether private equity funds generate outsized returns for limited partners (William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1863-64 (2018) (summarizing the empirical evidence on the issue)).

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in Parts I and II, highlighting the aspects of NAV Debt that could be detrimental to investors from contagion, conflict, governance and financial manipulation perspectives. In Part VI, after weighing the benefits and detriments of NAV Debt, this article makes recommendations for investment terms that investors in LBO funds should consider, and finishes with predictions for the future of NAV Debt. This article argues that NAV Debt can drive a coach and horses through the fine-tuned series of incentives and governance structures which have underpinned private equity during the boom times. Perhaps not quite a ticking time bomb, but in years to come we may look back at NAV Debt as a short-lived and ill-conceived short-term response to longer term economic headwinds.

I. THE TRADITIONAL PRIVATE EQUITY LBO MODEL

Winston Churchill once stated, "Without tradition, art is a flock of sheep without a shepherd. Without innovation, it is a corpse."[25] The quote could easily be applied to the private equity industry. LBOs have followed a traditional model over the last few decades, but with innovations that have enabled the industry to adapt to shifting economic climes. NAV Debt could be considered to be one of those innovations, but prior to discussing NAV Debt, it is germane to outline the traditional format of private equity LBOs and the fund structure that underpins the model.

A. *Fund Structure*

Many definitions have been ascribed to "private equity", but in the sphere of LBOs, a valid definition is, "The amalgamation of third party investments into finite lifetime funds to acquire interests in private companies (or public companies that are subsequently taken private), utilizing significant leverage, with a view to eventually selling those interests for a profit." Fundamental to that definition is the collation of equity finance from private investors into a "fund".[26] Such a fund is established and managed by the private equity firm, and it is the fund which then invests in portfolio companies.

Investors in a private equity fund have two overriding requirements – limited liability and the avoidance of double taxation. With respect to liability, investors will not accept liability for any of the acts or obligations of the fund.[27] From a tax perspective, investors in an LBO fund will not want to pay more tax than they would have done if they had invested directly in the relevant portfolio companies themselves.[28] The fund in which such investors invest must not be taxed on its returns so as to avoid double taxation at the fund-level and subsequently in the hands of investors upon a distribution. The

[25] Winston Churchill, *Speech to the Royal Academy, Burlington House, London* (April 30, 1953).
[26] TIMOTHY SPANGLER, THE LAW OF PRIVATE INVESTMENT FUNDS (3rd ed., 2018), at para. 1.02.
[27] Tim Jenkinson, Hyiek Kim and Michael S. Weisbach, *Buyouts: A Primer*, NBER WORKING PAPER SERIES NO. 29502 1, 9 (2021).
[28] SPANGLER, *supra* note 26, at para. 1.05.

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most common vehicle used for U.S. private equity funds is the limited partnership, with investors investing as limited partners in the fund.[29] The limited partnership neatly fulfils the tenets of investors – the liability of limited partners is limited to the contributions they make, or have committed to make, to the partnership,[30] and the limited partnership itself is tax transparent ("pass-through") for U.S. tax purposes and is not therefore taxed on any returns that it makes.[31] Although certain types of investors, such as U.S. tax-exempt and non-U.S. investors, may, for tax purposes, have a preference to invest in offshore corporations,[32] one structure that has become common is for a master fund to be established as a limited partnership, into which U.S. taxable investors invest, with U.S. tax-exempt and non-U.S. investors investing in offshore corporation "feeder funds",[33] that "feed" into the master fund as limited partners, with the master fund proceeding to acquire portfolio companies.

A limited partnership must have a general partner, which has unlimited liability for the debts and liabilities of the fund.[34] The general partner, owned and controlled by the private equity firm, is *prima facie* responsible for the management of the limited partnership, with limited partners largely excluded from management. If a limited partner becomes too closely entangled with management of the fund, it could lose the benefit of limited liability.[35] The limited partners contractually agree, within strictly defined limits, to make capital contributions to the fund ("commitments") when called upon by the general partner.[36] With the general partner having unlimited liability, it is usual for the general partner vehicle itself to be a limited liability entity, such as a limited liability company, and for it to have only token assets and employees, in order to insulate the private equity firm and its employees from any possible fund liabilities.[37] The private equity professionals who carry out the real work of

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[29] Jenkinson et al, *supra* note 27, at 8; Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 REV. FIN. STUD. 2303, 2304 (2010); William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. REV. 249, 259 (2017).

[30] For example, in Delaware, *see* 6 Del. C. § 17-303(a).

[31] Todd Henderson & William A. Birdthistle, *One Hat Too Many – Investment Desegregation in Private Equity*, 76 U. CHI. L. REV. 45, 50 (2009).

[32] U.S. tax-exempt investors and non-U.S. investors may suffer adverse tax consequences if they invest in a pass-through limited partnership that carries-out certain activities. For example, such investors could be taxed on gains if the partnership is engaged in a trade or business in the U.S. and therefore realizes U.S. effectively connected income (Morgan Lewis, *Accommodating Non-U.S. Investors: Understanding ECI*, VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES (2015) https://www.morganlewis.com/-/media/files/special-topics/vcpefdeskbook/fundformation/vcpefdeskbook_accommodatingnonusinvestors.pdf?rev=5223c7770fb148c095be254463af6d4e#:~:text=If%20a%20non%2DU.S.%20investor,U.S.%20federal%20income%20tax%20returns). Additionally, to the extent that the partnership incurs long-term acquisition debt, U.S. tax-exempt investors could be taxed on unrealized business taxable income (UBTI) (Morgan Lewis, *Accommodating Tax-Exempt Investors: Understanding UBTI*, VENTURE CAPITAL & PRIVATE EQUITY FUNDS DESKBOOK SERIES (2015) https://www.morganlewis.com/-/media/files/special-topics/vcpefdeskbook/fundformation/vcpefdeskbook_accommodatingtaxexemptinvestors.pdf?rev=7556bd334019486d801beacc040cb7a8). For further discussion on UBTI, *see* text accompanying *infra* notes 152-157.

[33] Nicole Kalajian, *Private Fund Structuring "101"*, VALUEWALK (June 9, 2020) https://www.valuewalk.com/private-fund-structuring-101/, at 10.

[34] Jenkinson et al, *supra* note 27, at 9.

[35] In a Delaware limited partnership, if a limited partner participates in the control of the fund's business, it will become liable to those persons who reasonably believe that the limited partner is a general partner (6 Del. C. § 17-303(a)).

[36] JOSH LERNER, FELDA HARDYMON & ANN LEAMON, VENTURE CAPITAL & PRIVATE EQUITY: A CASEBOOK (5th ed., 2012), at 67 (noting that limited partner commitments will not be contributed immediately upon the establishment of the fund, and a "takedown schedule" will commonly specify how and when commitments must be contributed).

[37] Jenkinson et al, *supra* note 27, at 11.

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managing the fund are housed within an investment manager entity to which investment management duties are delegated by the general partner.[38]

Private equity funds have finite lifetimes and are sometimes described as "closed-end" funds.[39] The traditional private equity fund has a ten-year lifecycle, although most funds also permit the general partner to extend the life-time of the fund by two to three years (and even further with limited partner consent).[40] For the first three to six years, the fund will be in an "investment phase" during which it can call on investors to make cash contributions which it will use to acquire portfolio companies.[41] Subsequent to, and also overlapping with, the investment phase is the "exit or harvesting phase", during which the fund can divest of investments. After the investment phase, the fund can only sell portfolio companies ("exits") and cannot call further capital from the limited partners to make fresh investments in existing or new portfolio companies. At the end of the fund's term, it must be dissolved and assets distributed to limited partners.[42]

B. *Private Equity Compensation*

In what is a standard theme with private equity, the fee arrangements for the industry are can be byzantine. A variety of fee structures exist, with significant diversity in payment mechanics. However, one model is the infamous "2 and 20" fee schedule. Under 2 and 20, the private equity firm is entitled to a management fee amounting to 2% of assets under management (usually including committed capital even if not drawn down from limited partners[43]), and performance-related compensation, known as the "carry or carried interest", equal to 20% of profits.[44] Although the numbers can vary between funds, 2 and 20 has proved remarkably sticky.[45] U.S. Federal and State tax regimes make it beneficial to the private equity firm for the management fee to be paid to the investment manager, and the carry to the general partner.[46]

Some buyout funds will taper the management fee, ramping it down over the lifetime of the fund.[47] During the investment phase, the private equity firm must undertake the heavy lifting identifying potential target companies, diligencing targets, negotiating transaction documents, and potentially suffering broken deal costs. After the investment phase, the firm's work is less burdensome when focusing on exits, making it harder to justify the full 2% management fee. Either the percentage is

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[38] *Id*., at 10.
[39] Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPECT. 121, 123 (2009).
[40] Jenkinson et al, *supra* note 27, at 13; Kaplan & Strömberg, *id.*, at 123.
[41] Blaze Cass, Andrew Gilboard and John Haggerty, *Private Markets Fees Primer*, MEKETA WHITE PAPER (October, 2019).
[42] Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, 33 DEL. J. CORP. L. 1, 11 (2008).
[43] Metrick & Yasuda, *supra* note 29, at 2310.
[44] *Id*., at 2310-11.
[45] Jenkinson et al, *supra* note 27, at 17.
[46] Debevoise & Plimpton, *Private Equity Funds: Key Business, Legal and Tax Issues* 1, 37, 45 (2020); Kalajian, *supra* note 33, at 5.
[47] TALMOR & VASVARI, *supra* note 1, at 32.

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simply reduced after the investment period, or, more commonly, the basis of its calculation changes from a percentage of contributed *and* committed capital to a percentage of remaining invested capital.[48]

In relation to the carry, limited partners prefer to see the general partner jump through hoops before receiving its performance-related portion of the fees. As such, it has become customary to include a "hurdle rate" condition, providing that the carry will only be paid if the limited partners have first received a minimum return – the "hurdle".[49] Histroically, the hurdle has oscillated around the 8% level.[50] Usually, the carry has a "catch-up" element, meaning that once the hurdle has been achieved, the general partner receives a sum equal to 20% of the total profits, rather than 20% of the profits received after deducting the hurdle return paid to the limited partners.[51]

A further complication persists in how the carry is calculated. Two approaches developed on each side of the Atlantic. Traditionally, in Europe, the carry would be determined on a whole-fund basis, such that the general partner would not be entitled to any carry until the limited partners had received the hurdle rate on their entire investment in the fund.[52] Therefore, even if the fund sells one of its portfolio companies at a large profit,[53] the general partner will not receive any of its carry until the fund has sold a sufficient number of its portfolio companies to enable the fund to distribute to the limited partners the entirety of their fund contributions plus the hurdle rate. The system became known as the European waterfall.[54]

In the U.S., a different mechanism developed, known as the American waterfall, pursuant to which the carry is paid on an investment-by-investment basis.[55] For example, if the fund exits a single portfolio company, and the return exceeds the limited partner contributions to that single investment plus the hurdle rate, the general partner will receive its carry on that investment.[56] In a plain vanilla American waterfall, it does not matter if the fund's other investments are in the red, the general partner still receives its carry on the single investment that made positive returns.

Clearly in the context of buyout funds, the American waterfall presents disadvantages for limited partners. An investor in a poorly performing fund overall could see the general partner receive a performance-related bonus as a result of, say, one fund portfolio company investment out of ten proving to be successful. No doubt it will stick in the throat of an investor if the general partner receives

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[48] *Id.* Cass et al., *supra* note 41 (the management fee may alternatively shift to a percentage of the net asset value of the portfolio after the investment period).
[49] Metrick and Yasuda, *supra* note 29, at 2312; Jenkinson et al, *supra* note 27, at 20.
[50] *Id.* It would be understandable for limited partners to demand a higher hurdle rate for funds established when interest rates are high (Sam Kay, *Private Equity Structures*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS, at 51 (Chris Hale, ed., 4th ed., 2020), (noting lower hurdle rates during low interest rate periods)).
[51] Metrick and Yasuda, *supra* note 29, at 2312.
[52] First National Realty Partners, *What is The Difference Between the American and European Equity Waterfall Structures?*, FNRP BLOG (March 2, 2022), https://fnrpusa.com/blog/american-vs-european-equity-waterfalls/#:~:text=In%20a%20European%20waterfall%2C%20the,time%20as%20the%20Limited%20Partners
[53] Typically private equity funds acquire five to fifteen portfolio companies (Morris & Phalippou, *supra* note 24, at 296), with the average, being ten over the life of the fund (Jenkinson et al, *supra* note 27, at 66).
[54] Eqvista, *Differences Between American and European Equity Waterfalls*, https://eqvista.com/equity/differences-american-european-equity-waterfalls/
[55] First National, *supra* note 52.
[56] Eqvista, *supra* note 54.

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performance-based compensation when the investor suffers an overall loss on its total investment in the fund. For buyout funds, it is not surprising therefore that a pure American waterfall has fallen out-of-favor in both the U.S. as well as Europe.[57] The European waterfall is not without its own challenges though - the general partner may have to wait many years before receiving a carry, possibly even until all the portfolio companies have been divested toward the end of the lifetime of the fund.[58] For the majority of the lifetime of the fund, the general partner may be required to sustain its costs solely through the management fee, which, as discussed, may ramp-down over the term of the fund. This can create difficulties for a small private equity fund, especially one with only one or few funds established, without significant resources.

Consequently, a hybrid waterfall has developed and become common across the buyout industry. The hybrid waterfall will in many respects resemble the American waterfall, but with a clawback mechanism in favor of limited partners.[59] Although the general partner receives the carry on a portfolio company-by-portfolio company basis, as investments are divested, a true-up must take place requiring the general partner to pay back a portion of the carry (usually net of tax paid on any portion of the carry received by the general partner) if the general partner received more than it should have done based upon a continuing whole fund determination of limited partner returns.

The description of private equity fees above has been generalized to an extent, and the exact fees, mechanics of determination, and schedule of payments will vary on a fund-by-fund basis. Private equity firms may also charge fees at the portfolio company level, including transaction fees each time an acquisition, disposal or restructuring takes place, arrangement fees when debt is refinanced, and ongoing advisory or monitoring fees.[60] With some funds, those portfolio company fees are netted from management fees paid to the investment manager or shared with limited partners,[61] whereas in other funds those fees represent legitimate supplementary remuneration for the private equity firm. An infinite number of variations are possible in the manner in which private equity firms are paid. Even before NAV Debt is brought into the equation, the complexity of compensation structures can obscure assessments of whether the private equity firm is extracting a correctly determined level of fees, and exactly what incentives on the firm develop as a result of the fee structure as a whole.

[57] Ji-Woong Chung & Hong Jeong, *Waterfall in Private Equity*, in DOUGLAS CUMMING & BENJAMIN HAMMER (eds.) THE PALGARVE ENCYCLOPEDIA OF PRIVATE EQUITY (2023). Debevoise, *supra* note 46, at 39 (noting that a private equity firm establishing its first fund, or without an extensive track record, will unlikely be able to insist on a pure American waterfall).
[58] Eqvista, *supra* note 54.
[59] *Id*.
[60] Metrick and Yasuda, *supra* note 29, at 2313.
[61] Kaplan & Strömberg, *supra* note 39, at 124; Jenkinson et al, *supra* note 27, at 19.

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C. *The Use of Debt*

It's all in the name. The moniker "*leveraged*" buyout, reflects the use of high levels of debt to complete portfolio company acquisitions.[62] Traditionally, private equity buyouts have employed 60-90% debt with the remainder provided by equity contributions from the limited partners.[63] Although the current high interest environment has naturally seen a decline in the proportion of debt employed on buyouts, with one study finding a new low of 48% debt in large LBOs in 2023,[64] debt still forms a large proportion, if not a majority, of buyout consideration.

Why so much debt? The answer lies partly in the practical, and partly in the existential. Practically, debt supplements the funds available for buyouts. Not only does that bring larger, potentially publicly-traded, targets into play, but it also allows the fund to diversify its interests.

More fundamentally, debt is vital to the success of the private equity LBO business model in two regards. First, the debt can be structured in a way that allows for the interest on that debt to be deductible from the pre-tax profits of the relevant portfolio company.[65] Such a "tax shield" reduces the taxable income of the portfolio company, in turn reducing its tax burden. Second, debt leverages positive returns.[66] To take a simplified example - if a portfolio company is acquired by a fund for $500 million, solely with equity contributions from limited partners, and sold for $1 billion five years later, the return on investment is two times. However, if the same acquisition were completed using 50% debt, upon the sale five years later, the fund receives $750 million (after the repayment of the $250 million loan) on a $250 million equity investment – a return of three times. If the capital of the fund is deployed on a similar leveraged basis across multiple portfolio companies, returns can be enhanced across the board. Although, of course, this simplified example does not take into account interest on the debt, so long as the enterprise value of the portfolio company increases at a greater rate than the interest on the debt, the use of debt boosts returns as compared to a pure equity-funded acquisition.

Debt is the (not so) secret sauce of private equity, once described as the "rocket fuel" of the industry.[67] When interest rates were barely above zero, high levels of leverage could easily facilitate better returns for investors in LBO funds than unleveraged investments in public equity. Even if the private equity firm offered little in the way of added value to its investments, so long as the performance

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[62] Jenkinson et al, *supra* note 27, at 8.
[63] Kaplan & Strömberg, *supra* note 39, at 124. Ulf Axelson et al, *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in* Buyouts, 68 J. FIN. 2223, 2239 (2013) (finding that for LBOs between 1986 and 2008, LBO average debt utilized was 70%).
[64] Wachtel, Lipton, Rosen & Katz, *Private Equity in 2023 – A Year (Not) to Remember* 1, 3 (January 10, 2024), https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28472.24.pdf
[65] *E.g.* 26 U.S.C. § 163(a). In relation to the use of the tax shield in private equity, *see* Jenkinson et al, *supra* note 27, at 39; Kaplan & Strömberg, *supra* note 39, at 131, 134.
[66] Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 252 (2009); Tim Vipond, *LBO Model*, CORPORATE FINANCE INSTITUTE https://corporatefinanceinstitute.com/resources/financial-modeling/lbo-model/
[67] Henry Sender, *How Could Buyers Resist Taking Those Terms*, THE WALL STREET JOURNAL (August 25, 2007), https://www.wsj.com/articles/SB118799505991608357 (quoting Bill Conway, co-founder of Carlyle).

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of those portfolio companies in terms of firm value matched the public markets (even only as a result of generally improving economic conditions), returns would be much higher than equivalent unleveraged investments in public equity. The conventional use of debt by LBO funds should, though, be distinguished from NAV Debt. As discussed in the next section, traditionally, debt used to finance acquisitions in not incurred at the fund-level.

D. *The "Rules" of Private Equity Funds*

Two informal related "rules" have underpinned the private equity buyout fund model. First, no liabilities or debt should be incurred at the fund-level. Second, each portfolio company investment should be siloed and insulated from each other.

With respect to the first "rule", historically it has been rare for the fund itself to incur any substantial debt.[68] The concept derives from a desire to keep the fund "clean" of liabilities. The principal activities of the fund itself are to receive capital contributions from, and to distribute returns (after deduction of fees) to, limited partners. The intention is to ensure that liabilities or creditors cannot attach to the accounts of the fund that hold contributions and distributions prior to transfer of those sums, so that contributions can be freely and fully used for acquisitions, and returns from investments can be freely and fully distributed to the limited partners after extraction of fees.

The only type of debt incurred at the fund-level in the traditional private equity business model is short-term borrowing through "subscription facilities". Subscription facilities are fixed or revolving credit facilities that allow the fund to draw cash in anticipation of limited partners satisfying their drawdown commitments.[69] Since limited partners will likely have a non-trivial notice period within which to provide capital,[70] if the fund needs to move quickly on an acquisition, such as during a competitive auction process, it can simply borrow sums equivalent to the limited partners' commitments to proceed with the acquisition. Once the limited partner satisfies its commitment, the sum is immediately used to pay-down the debt incurred.[71] Normally, subscription lines of credit are unsecured, although if the loans have longer terms than is usual (for example, if the limited partners have long notice periods within which to contribute committed capital), lenders may request security over uncalled limited partner capital commitments.[72] For larger private equity funds, with sophisticated, well-

[68] Jenkinson et al, *supra* note 27, at 26.
[69] Jenkinson, *supra* note 27, at 14; Leung & Balasubramanian, *supra* note 11.
[70] The standard drawdown notice period is 10 to 15 business days (Thomas Draper, Patricia Lynch and Dan Coyne, *Capital Call Subscription Facilities: The Borrower's View*, in GLOBAL LEGAL INSIGHTS: FUND FINANCE 2017, at 58 (Michael Mascia ed., 1st ed., 2017)).
[71] Jenkinson, *supra* note 27, at 14; Leung & Balasubramanian, *supra* note 11.
[72] Jenkinson, *id.*, at 14; Institutional Limited Partners Association (ILPA), *Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners* (June 2017).

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resourced limited partners, such debt is viewed as low-risk for the fund and lenders.[73] The debt merely solves a timing issue for the fund.

It is not uncommon for limited partnership agreements to prohibit or restrict the fund itself from incurring debt other than short-term subscription facilities.[74] Similarly, other than related-party relationships such as the investment management agreement with the investment manager, the fund rarely enters into contracts or assumes obligations.[75] With the possible exception of equity commitment letters discussed further below,[76] generally the fund will have no obligations to third parties, and, therefore, will not suffer liabilities.

The second rule flows naturally from the first. If debt is a large part of the private equity business model, yet the fund itself does not incur that debt, a borrowing structure must be implemented that isolates the fund from any debt incurred. In so doing, each portfolio company neatly becomes siloed within a separate investment structure.

The acquisition structure in a private equity LBO can be complex, and jurisdiction-specific, but a simple typical U.S. buyout structure can be generalized, as shown in Figure 1. The fund itself will not directly acquire a portfolio company. Instead, the fund will establish a series of SPVs, usually limited liability companies, to acquire the target.[77] The fund subscribes to shares in a "topco" vehicle with the capital contributions made by limited partners.[78] Topco itself subscribes for shares in a "bidco" vehicle using the subscription proceeds it has received from the fund.[79] It will be bidco that incurs the debt to acquire the portfolio company, and bidco that enters into the stock purchase agreement with the sellers of the target.[80] Upon closing, bidco will pay the purchase price for the target to the sellers from the finance provided by both the debt and limited partner contributions (through topco), and the target becomes a subsidiary of bidco or bidco will merge into the target company.

As well as guarantees given by the SPVs, the portfolio company (and its subsidiaries) will guarantee the repayment of the principal and interest of the debt, as well as provide security over all its assets.[81] Recently, the vast majority of LBOs have been financed through direct lending (lending from sources that do not involve an intermediary bank, usually from private credit funds)[82] which is

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[73] Jenkinson, *supra* note 27, at 14.

[74] Patricia C. Lynch & Patricia Texeira, *NAV Financing: A Terrific Tool for Savvy Fund Sponsors*, ROPES AND GRAY INSIGHTS (October 11, 2022); Kaplan & Strömberg, *supra* note 39, at 123.

[75] William Curbow, Kathyrn Sudol & Atif Azher, *Getting the Deal Through: United States*, in PRIVATE EQUITY 2011 (2011), at 310-11 (Casey Cogut ed., 2011) https://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/publications1221_2.pdf

[76] *See* text accompanying *infra* note 88.

[77] Simon Skinner, *Structuring Private Equity Transactions: Tax and Management Planning*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS, at 210 (Chris Hale, ed., 4th ed., 2020). The entity-types and jurisdictions of incorporation are tax-driven.

[78] *Id.*

[79] *Id.*

[80] *Id.*

[81] Kirstie Hutchinson & Christopher Lawrence, *Debt Finance*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS, at 107 (Chris Hale, ed., 4th ed., 2020).

[82] Through the third quarter of 2023, 86% of LBO debt was provided by direct lending (Wachtel, *supra* note 64, at 3).

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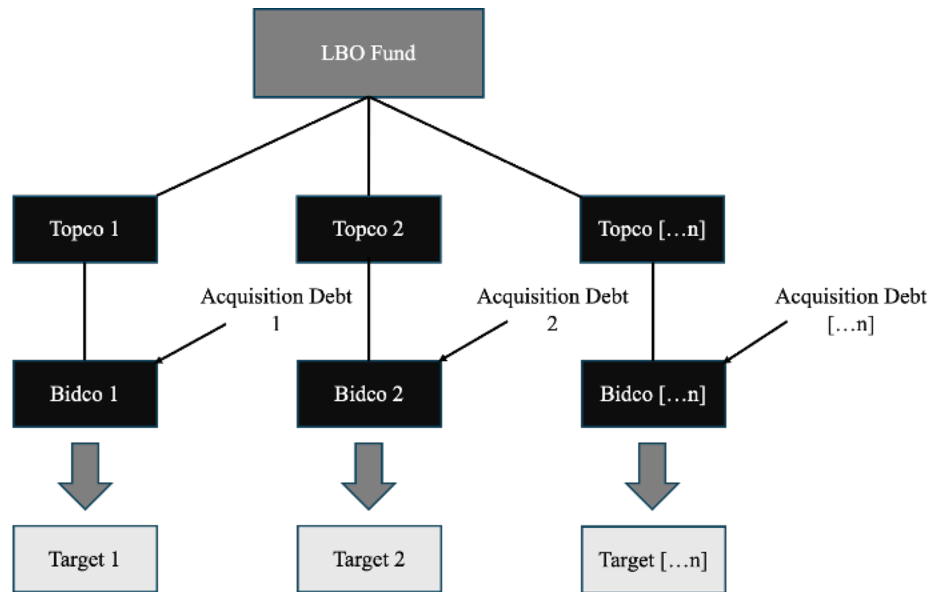

Figure 1: Simplified Private Equity LBO Acquisition Structure

provided on a "unitranche" basis negating the need for further debt funding from other sources.[83] If unitranche lending is not utilised, and the debt is split into senior debt and junior debt underwritten by different finance providers,[84] the acquisition structure will often include a further "midco" vehicle between topco and bidco which borrows the junior debt.[85] The extra SPV in the structure pushes the senior debt closer to the target's assets than the junior debt, thereby structurally subordinating the junior debt to the senior debt.

The consequence of utilizing SPVs that are limited liability entities is that the fund is not itself liable to repay the debt incurred to acquire the portfolio company, with its liability limited to the capital it has subscribed in topco as a shareholder. Since the SPVs have little in the way of assets after closing of the acquisition, the lender will seek to enforce against the assets of the portfolio company if there is a default on the debt, and so, controversially, in essence the debt is pushed down to the portfolio company.[86] The lender cannot enforce against the fund or any of its other assets.

The acquisition structure described above will be repeated for each portfolio company acquisition, with acquisition-specific topcos and bidcos incorporated in each case as shown in Figure 1. Therefore, not only is a lender on one acquisition precluded from enforcing against the fund upon a default, but is also precluded from enforcing against the assets of any other portfolio company owned by the fund.[87] The portfolio companies are effectively isolated from each other, with individual borrowers and lenders

[83] Hutchinson & Lawrence, *supra* note 81, at 95-6.
[84] Kaplan & Strömberg, *supra* note 39, at 124-25.
[85] Skinner, *supra* note 77, at 210.
[86] Eileen Appelbaum & Rosemary Batt, *A Primer on Private Equity at Work: Management, Employment, and Sustainability* 55 CHALLENGE 5, 14 (2012); Jenkinson et al, *supra* note 27, at 11.
[87] Elisabeth De Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANK. & FIN. L. 115, 122 (2013-2014).

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for each acquisition. If there is a default under one debt facility, the lender can only enforce against the assets of the portfolio company for which the debt was used to acquire. Such a silo structure is self-evidently beneficial to both limited partners and the general partner, since, for limited partners, one poor investment of the fund will not distress returns from other fund investments, and the general partner can write-off one failed investment and still hope that it can receive a carry if the loss on that investment is significantly outweighed by the gains on the other investments of the fund.

A possible exception to the "rules" outlined above is the equity commitment letter. Since a seller of a target company will likely be contracting directly with a shell SPV, it will seek some assurance that bidco will be put into funds to close the relevant acquisition. Equity commitment letters have become common whereunder the fund agrees to subscribe for shares in topco at a price equal to the intended equity contribution to the purchase price for the acquisition (or, at least the reverse break fee to the extent one has been negotiated), and, in turn, topco agrees to subscribe for shares in bidco at the same price.[88] For larger private equity funds with robust reputations, the fund may have sufficient bargaining power and reputational credit to insist that the equity commitment letter is purely an internal agreement between the fund, topco and bidco, and, therefore, only enforceable by those entities. The equity commitment letter is therefore only an exception to the rules to the extent that a seller negotiates an obligation directly from the fund to the seller to subscribe for shares in topco, or a right of specific performance to enforce the terms of the equity commitment letter. In any event, the obligations under the equity commitment letter are fully within the hands of the fund, and simple to satisfy, and therefore unlikely to prejudice the desire to ensure that the fund is "clean" of liabilities.

Adherence to the "rules" elegantly protects the fund from liabilities and insulates investments in siloes. Those rules, together with the ways in which funds are structured and private equity firms remunerated, create incentives that have a substantive influence on private equity governance, as discussed in the next Part of this paper.

II. PRIVATE EQUITY GOVERNANCE 101

The theory of agency costs was first developed in the context of the apparent conflicts that could emerge between the interests of shareholders in corporations and the managers of those corporations.[89] The economic theory is that where an economic (rather than legal) agent has responsibility for managing the assets of a principal, the agent, since its own wealth is not at risk, may manage those assets poorly or negligently, or use the assets for its own private benefit.[90]

[88] Curbow et al., *supra* note 75, at 310-12.

[89] *See e.g.* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).
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[90] Jensen & Meckling, *id.*, at 308, 312-330.

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The private equity paradigm is not immune to agency costs. Agency costs can arise at the fund-level, and at the portfolio company-level. In this Part II, the conflicts of interest and governance challenges that can create agency costs are identified, together with how the traditional private equity LBO model described in Part I creates an ecosystem that minimizes the propensity for those conflicts to compromise limited partner returns. Later we will discuss how the introduction of NAV Debt could unbalance the model and its governance benefits.

A. *Agency Costs at the Fund-Level*

From an economic agency point-of-view, at the fund-level, the principals are the limited partners who contribute their capital to the fund for the private equity firm, as the agent, to manage on their behalf. Extrapolating agency costs theory, the investors will be concerned that the private equity firm may not manage their capital effectively to maximize investor returns, or, even worse, may utilize that capital primarily to extract private benefits for itself.[91]

Investors in private equity buyout funds seek to reduce agency costs in three ways – (i) proactively, by monitoring the actions of the private equity firm;[92] (ii) economically, by aligning the interests of the private equity firm with the limited partners;[93] and (iii) contractually, through protections in the limited partnership agreement.[94]

In relation to monitoring, limited partners will be particularly motivated to ensure that their capital is being managed effectively if they have a large amount of capital committed to the fund. However, two aspects deter such individual monitoring. The free-rider deterrence that afflicts monitoring of management by shareholders in dispersed ownership publicly traded corporations[95] is also apparent, to a lesser degree, in private equity funds.[96] On an individual basis, a single limited partner may be hesitant to expend the costs and resources to monitor the firm when it could simply free-ride off the efforts of another limited partner's monitoring and avail itself of the same benefits as if it had undertaken the monitoring itself. Additionally, if a limited partner becomes too entwined with the management of the fund, it will, as discussed, lose its limited liability.[97] A common solution is to constitute a limited partner advisory committee (LPAC) in the partnership's constitutional documents, comprised of a sub-set of limited partners.[98] Usually, the largest investors in the fund (or those with longstanding relationships with the private equity firm) will serve on the LPAC.[99] The LPAC neatly deals with free-rider issues,

[91] William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67, 75 (2020).
[92] WITNEY, *supra* note 24, 187-93.
[93] TALMOR & VASVARI, *supra* note 1, at 33.
[94] Clayton *supra* note 91, at 75.
[95] In relation to the separation of ownership and control in dispersed ownership publicly-traded companies caused by free-rider and collective action issues, *see* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
[96] Clayton, *supra* note 29, at 272.
[97] *Supra* note 35, and accompanying text.
[98] Kobi Kastiel & Yaron Nili, *The Rise of Private Equity Continuation Funds*, 1, 38 (2023), https://ssrn.com/abstract=4586497
[99] *Id*.

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since monitoring costs are shared amongst the members of the committee. Furthermore, the LPAC will not become involved in management decisions *per se*, with the role of the LPAC clearly defined. The LPAC will have regular meetings with the firm at which it can ask questions about the fund and its investments, and exercise consent rights.[100] Key to the effectiveness of the LPAC, however, is ensuring that there is a clear channel of information flow from the private equity firm, and that material conflicts of interest do not exist between individual limited partners.

Aligning the interests of the agent and the principal is a classic approach to reducing agency costs. The carry, especially when combined with a hurdle rate, could be considered to be an effective means of tying the interests of the private equity firm to the interests of the limited partners, as it motivates the firm to maximize returns on investments.[101] The carry is not, though, a perfect agency cost-minimizing tool, since a healthy guaranteed management fee could either weaken its influence, or incentivize the private equity firm to take excessive risks to swell the carry. Therefore, often limited partners will further require the firm to co-invest with the limited partners – ensuring that the private equity firm has "skin-in-the-game".[102] The firm will either invest its own resources in the fund itself, or will co-invest alongside the fund as a direct investor (through a co-investment fund) in each portfolio company.[103]

Limited partners also protect their rights and potentially reduce agency costs contractually by negotiating terms into the limited partnership agreement.[104] At a fundamental level, the limited partnership agreement will specify the capital commitments of each limited partner, when they can be called and on what notice, allocations of limited partners, restrictions over when the firm can establish future funds, and duties, responsibilities and liabilities of the general partner and investment manager.[105] Importantly, the limited partnership agreement will also put the private equity firm under an onus to obtain the acquiescence of the limited partners before taking certain actions.[106] The terms that could be negotiated will of course depend upon the bargaining strength of the limited partners, but, at least in theory, for every agency cost that could emerge, a contractual solution could be drafted into the limited partnership agreement.

A further provision in the limited partnership agreement that can have a seismic influence on behavior is the duration of the fund. With a finite period after which the fund must be dissolved,[107] the private equity firm is on the clock from the day the fund is established. Not only is there an incentive on the private equity firm to work assiduously to identify, diligence and acquire suitable targets, but having acquired those portfolio companies, there is an impetus to make those companies more efficient

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[100] TALMOR & VASVARI, *supra* note 1, at 26, 107.
[101] LERNER ET AL., *supra* note 36, at 71; Elisabeth de Fontenay, *Private Equity's Governance Advantage: A* Requiem, 99 B. U. L. 1095, 1105 (2019).
[102] Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 287 (2010); and Kaplan & Strömberg, *supra* note 39, at 123 (noting that it is customary for the general partner to contribute at least 1% of the total capital).
[103] Kay, *supra* note 50, at 52.
[104] Jenkinson et al, *supra* note 27, at 13.
[105] TALMOR & VASVARI, *supra* note 1, at 105-9.
[106] *Id*.
[107] *See* text accompanying *supra* notes 40-42. Jenkinson et al, *supra* note 27, at 13 (noting that the average life of an LBO fund is around 13 years).

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and/or grow the businesses, and generally increase profitability as soon as possible, since returns from exits must be crystalized before the fund is dissolved - the firm's feet are held to the fire, forestalling proclivities toward passivity or inertia.[108] That time pressure is likely one of the factors buttressing the success of private equity-backed companies.

However, the quixotic aspiration that sophisticated limited partners will be able to effectively negotiate LPAC monitoring rights, agency cost-reducing fee structures and waterfalls, and limited partnership agreement consent requirements is somewhat crushed by the pervasiveness of private agreements between individual limited partners and the fund, granting specific benefits or rights that may not be offered to all limited partners under the limited partnership agreement ("side letters").[109] Although side letters may be fairly benign and simply relate to regulatory or tax requirements specific to a particular limited partner, they could also be broader in nature and grant the relevant limited partner more beneficial fee arrangements, kickbacks on the private equity firm's fees, or co-investment opportunities in future portfolio company investments of the fund.[110] The prevalence of side letters can create conflicts of interest between limited partners, and could cause the theory of "private ordering" to break down, since individual limited partners may be less inclined to negotiate rights into the limited partnership agreement that are beneficial to all limited partners when they have already protected their personal position or have other compensatory benefits under a side letter.[111] Core, favored or repeat customers of the private equity firm may be able to garner such side letter rights to the detriment of smaller or less frequent investors.[112]

The SEC recently enacted rules that will require funds to disclose all side letters to investors and potential investors,[113] and prohibit preferential redemption or information rights to the extent that they have a material negative effect on other investors.[114] Time will tell if the SEC's new rules have a substantive impact on private equity governance, but, for the time being, it is vital to understand that not all limited partners are equal when assessing the merits of private equity adaptations, such as NAV Debt.

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[108] Cheffins & Armour, *supra* note 42, at 14.

[109] Debevoise, *supra* note 46, at 31-32; Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. UNI. L. REV. 907, 930 (2023).

[110] Jenkinson et al, *supra* note 27, at 11; Magnuson, *supra* note 24, at 1886; Fontenay, *supra* note 101, at 1119. The propensity for side letters to include terms that are not benign to other investors is not clear – Fontenay & Nili, *id*., at 949 (finding that side letters generally cater for regulatory and tax requirements); Jessica S. Jeffers & Anne M. Tucker, *Shadow Contracts*, 1 U. CHI. BUS. L. REV. 259, 283 (2022) (finding that economically significant terms such as fee discounts and co-investment opportunities are common).

[111] Clayton *supra* note 91, at 70, 91-93; Kastiel & Nili, *supra* note 98, at 11; William W. Clayton, *High-End Securities Regulation: Reflections on the SEC's 2022-23 Private Funds Rulemaking*, 14 HARV. BUS. L. REV. 71, 104 (2024); Fontenay & Nili, *supra* note 109, at 963; Magnuson, *supra* note 24, at 1897.

[112] Magnuson, *id*., at 1886; Marco Da Rin and Ludovic Phalippou, *The Importance of Size in Private Equity: Evidence from a Survey of Limited Partners*, 31 J. FINAN. INTER. 64, 71 (2017); Clayton, *supra* note 29, at 254, 268.

[113] 17 CFR 275.211(h)(2)-3(a).

[114] 17 CFR 275.211(h)(2)-3(b).

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B. *Agency Costs at the Portfolio Company-Level*

Extending the agency costs concept, at the portfolio company-level, the fund is the principal, and the managers of the portfolio company the economic agents. Similar to reducing agency costs at the fund-level, at the portfolio company-level, the fund, as principal, reduces agency costs by monitoring, aligning the interests of the managers and the fund, and contractually constraining the acts of managers.

The fund has meaningful incentives, and, as a majority owner, the power, to monitor management.[115] The fund will likely not be as diversified as an institutional shareholder in a publicly traded firm,[116] will have a significant majority interest in the portfolio company, and has an interest which is largely illiquid.[117] Furthermore, emphasizing the finesse of the private equity LBO model, and tying together the fund and portfolio company tiers, ensuring that portfolio companies are successful is vital to the private equity firm's reputation when fund-raising for future funds, and for securing and enlarging the carry. The private equity firm will have a laser-like focus on the progress of portfolio companies through the fund as shareholder and directors it will have nominated to the board of each such company.[118]

Along with the pressure on private equity funds to turn a profit on investments within a short period of time,[119] the potent alignment of portfolio company manager interests with the interests of the fund inherent in the LBO model is likely a critical element that drives LBO portfolio company performance.[120] Managers of private equity-backed portfolio companies tend to have higher equity interests in those companies than their professional brethren in publicly traded companies, and their rewards are highly performance-related.[121] It is also customary for the equity interests of such managers to embody significant upside potential, with their equity share on an exit increasing if the fund makes threshold returns.[122] Moreover, at the time of acquisition, managers will also be required to invest their own cash in topco giving them substantive skin-in-the-game and further aligning their interests with those of the fund.[123]

It is not simply alignment through management rewards and equity though that blunt agency costs. Alignment is also embossed through the very utilization of high levels of debt in the acquisitions. In the standard LBO model, acquisition debt is essentially pushed-down to the portfolio companies,[124] saddling them with far more debt than the typical publicly-traded company. Several studies have

[115] Fontenay, *supra* note 87, at 119; Masulis & Thomas, *supra* note 66, at 228; Magnuson, *supra* note 24, at 1860.
[116] *Supra* note 53.
[117] LERNER, *supra* note 36, at 6.
[118] Masulis & Thomas, *supra* note 66, at 228.
[119] *See* text accompanying *supra* notes 107-108.
[120] Luc Renneboog & Tomas Simons, *Public-to-Private Transactions: LBOs, MBOs, MBIs and IBOs*, TILEC DISCUSSION PAPER 2005-023 1, 8-9 (August 2005).
[121] Masulis & Thomas, *supra* note 66, at 252; Kaplan & Strömberg, *supra* note 39, at 130.
[122] Fontenay, *supra* note 101, at 1104; Morris & Phalippou, *supra* note 24, at 295.
[123] Kaplan & Strömberg, *supra* note 39, at 131.
[124] *Supra* notes 81, 86, and accompanying text.

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commented upon the propensity for debt to have a disciplining effect on managers.[125] With the need to service regular interest payments, the free cash available to satisfy managers' private benefits, invest in unprofitable projects or to empire-build is reduced.[126] To the extent that free cash is available after servicing debt, managers will also be under pressure from their private equity minders to make distributions to the fund. Additionally, debt covenants under facility agreements tie the hands of management, requiring them to adhere to strict budgets.[127] High leverage has been identified as a significant advantage in the private equity LBO model over the stereotypical publicly-traded company.[128]

Agency costs are also reduced through contractual means. The equity-based compensation of portfolio company managers leads to them becoming shareholders in topco, and parties to a stockholders' agreement.[129] The stockholders' agreement will inevitably include various contractual provisions prohibiting managers from taking actions that would have a material effect on the financial prospects of the company without fund consent.[130]

The reliable facets of the private equity LBO model from fund structuring and private equity compensation through to acquisition structuring and the use of debt, create the tools that mitigate conflicts at both the fund- and portfolio company-levels. The model is finely balanced to fashion an environment that should lend itself to high returns for limited partners and highly performing portfolio companies. However, the reliability of that model may be questioned when NAV Debt is thrown into the mix.

III. THE INTRODUCTION OF NAV DEBT

Whereas in Part I it was noted that the rules of private equity LBOs specify that the fund should have no liabilities and should not incur any long-term debt, NAV Debt has entered the fray tearing-up the rules. In this Part, the nature and operation of NAV Debt is outlined, as it has become a mainstay of the brave, new high interest rate world of private equity.

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[125] *E.g.* Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324-25 (1986); Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.–Oct. 1989); Kaplan & Strömberg, *supra* note 39, at 131.
[126] *Id*.
[127] Krishna G. Palepu, *Consequences of Leveraged* Buyouts, 27 J. FIN. ECON. 247, 251 (1990); Cheffins & Armour, *supra* note 42, at 13.
[128] Jensen, *Eclipse*, *supra* note 125.
[129] WITNEY, *supra* note 24, at 48.
[130] DARRYL J. COOKE, PRIVATE EQUITY: LAW AND PRACTICE, at 196-8 (7th ed., 2021).

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A. *The Nature and Structure of NAV Debt*

NAV Debt is debt at the fund-level, or at least debt for which the fund could become liable to repay, borrowed against the value of that fund's entire investment portfolio, net of any asset-level debt.[131] Unlike a subscription facility which looks "upward" toward the uncalled commitments of limited partners, a NAV facility looks "downward" toward the portfolio company assets owned by the fund.[132] A lender will determine whether to make the loan based upon the value of all the portfolio companies owned by the fund, distinguishing it from the acquisition finance seen in traditional LBOs which is backed by the value of the assets for which the loan is being used to acquire.[133]

NAV Debt can take the form of either a term or revolving credit facility.[134] However, since the uses of NAV Debt generally relate to specific transactions and repayment of the loan will be on a relatively long-term basis, it is more usual for NAV Debt to be constituted as a term facility.[135] A lender will assess the amount of debt it is prepared to lend based upon an "advance rate",[136] which is the proportion of the value of the fund's assets that a lender is willing to extend as a loan. The advance rate will *prima facie* be applied against the value of each of the fund's portfolio companies less any asset-level debt (including acquisition debt).[137] It is not unusual for the lender to require an independent valuation of the assets rather than relying upon the net asset value routinely communicated to the fund's limited partners.[138] The lender may also insist that the net asset value is discounted to account for the relative illiquidity of the assets.[139] Certain assets will be excluded from the calculation – for example, if a portfolio company is in bankruptcy, has defaulted under its finance facilities, or has breached a material agreement.[140] Lender diligence of the portfolio will therefore be extensive.[141] The advance rate may also integrate a concentration limit - if the lender is concerned that the assets owned by the fund are not sufficiently diverse and, for instance, are concentrated in a particular industry, the lender will apply a limit to the proportion of assets from that industry that can form part of the net asset value of the fund's assets.[142]

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[131] Kiel A. Bowen et al., *The Advantages of Net Asset Value Credit Facilities*, MAYER BROWN INSIGHTS (March 29, 2023); Lightbrown, *supra* note 18; Kerfoot & Joo, *supra* note 13.
[132] Dworkin & Hait, *supra* note 12, at 101; Loyens & Loeff, *NAV Facilities: A Strategic Tool,* LOYENS & LOEFF INSIGHTS (June 9, 2023). "Hybrid" facilities have also emerged which combine subscription facilities and NAV Debt facilities, and are therefore upward- and downward-looking (Leung & Balasubramanian, *supra* note 11; Dworkin & Hait, *id*., at 104; Loyens & Loeff, *id*.).
[133] *Supra* note 81, and accompanying text.
[134] Lynch & Texeira, *supra* note 74.
[135] Bowen et al., *supra* note 131.
[136] *Id*. Since NAV Debt is lent against a base of assets with a total line of credit defined as a proportion of the asset value, it is sometimes described as a "borrowing base" facility (Jason Bazar et al., *Net Asset Value Credit Facilities*, MAYER BROWN INSIGHTS (July 29, 2013); Vittorio Casamento, *Navigating the Growth of NAV and Hybrid Facilities in Funds Finance*, NORTON ROSE FULBRIGHT THOUGHT LEADERSHIP (June 2023)).
[137] Stephenson & Jones, *supra* note 14.
[138] Bazar et al., *supra* note 136.
[139] *Id*.
[140] *Id*.; Leung & Balasubramanian, *supra* note 11; Dworkin & Hait, *supra* note 12, at 101; Bowen et al., *supra* note 131.
[141] Leung & Balasubramanian, *id*.; Loyens & Loeff, *supra* note 132.
[142] Lynch & Texeira, *supra* note 74; Dworkin & Hait, *supra* note 12, at 101; Bowen et al., *supra* note 131.

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It would appear that advance rates on NAV Debt are typically in the 10-30% range,[143] giving a lender substantial headroom on the "loan to value" (LTV) for the facility. There is a wide diversity in NAV Debt LTVs though, with some commentators noting the range to be higher in the 30-40% range[144] and others noting that for larger funds, NAV Debt can have an LTV less than 10%.[145] Since the NAV Debt is subordinated to acquisition debt,[146] the NAV Debt lender will require that LTV headroom to give it a buffer if net asset value were to drop as a result of economic conditions or poor portfolio company performance.[147] Ultimately, the LTV will come down to a combination of the sums that the fund is seeking to borrow, the size of the fund, and how much the lender is willing to risk lending based upon the quality and cash-flow potential of the assets, and the track record of the private equity firm. A wide variety of lenders have entered the market. Traditional lenders such as banks will lend to high quality funds, but with high interest rates increasing the potential for returns, private credit funds have also become prolific NAV Debt lenders, and even insurance companies have been enticed to the asset class.[148]

B. *Fund-Level and Portfolio-Level Obstacles to NAV Debt*

The simplest structure for NAV Debt involves the fund itself borrowing directly and extending security in favor of the lender. However, the limited partnership agreements of many funds do not permit lending at the fund-level other than short-term subscription facilities,[149] and some vintage funds, maintaining a strict adherence to the rules of private equity LBOs, do not even permit subscription facilities.[150] Notably, the terms of newer funds, established during the high interest rate economic climate, are providing for wider scope for the incurrence of fund-level NAV Debt, resonating with the mainstream emergence of NAV Debt in the current market.[151]

Another obstacle to fund-level borrowing is the possible adverse tax consequences for investors in the fund. Certain types of investors, such as U.S. tax-exempt investors, which includes a broad range of potential investors in private equity, including pension funds, university endowments and not-for-profits, can lose their tax exemption if they invest in a partnership that incurs long-term debt, since income derived from property subject to "acquisition indebtedness" (including post-acquisition debt that would not have been incurred but for the acquisition) could be deemed to be unrealized business

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[143] Lynch & Texeira, *id.*
[144] Thomas Doyle, *Why LPs are Warming to NAV Financing*, PRIVATE DEBT INVESTOR (October 2023), https://www.privatedebtinvestor.com/pemberton-asset-management-why-lps-are-warming-to-nav-financing/. A Deloitte study had the range at 25-30% (Financier Worldwide, *supra* note 21).
[145] Kerfoot & Joo, *supra* note 13.
[146] *Infra* note 166, and accompanying text.
[147] Lynch & Texeira, *supra* note 74.
[148] Lynch & Texeira, *id.*; Bowen et al., *supra* note 131.
[149] S*upra* note 74, and accompanying text.
[150] Dworkin & Hait, *supra* note 12, at 101; Bazar et al., *supra* note 136.
[151] Lynch & Texeira, *supra* note 74.

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taxable income (UBTI).[152] Usually subscription debt is short-term and does not create UBTI issues for U.S. tax-exempt investors, and acquisition debt incurred through the silo structure described earlier, similarly does not create issues, since the corporate SPVs utilized block the fund itself from the incurrence of debt.[153] NAV Debt incurred directly at the fund-level, though, would likely fall within the UBTI regime.[154] As discussed, most often U.S. tax-exempt investors will protect their tax positions by investing through a non-partnership feeder fund which effectively acts as a tax blocker against UBTI issues at the master fund level.[155] However, to the extent that there are U.S. tax-exempt investors invested directly in the master fund limited partnership,[156] NAV Debt could have significant consequences for those investors, in which case, long-term fund-level debt will likely be prohibited in the limited partnership agreement or within side letters.[157]

If the fund cannot directly borrow NAV Debt, it can incorporate an SPV (the "NAV SPV") as the borrower.[158] The use of a NAV SPV does not contravene prohibitions on the fund itself incurring debt, and it acts as a blocker for U.S. tax-exempt investors fearing UBTI consequences. Ideally, from the lender's perspective, the fund then guarantees the debt and obligations of the NAV SPV.[159] However, if the fund's limited partnership agreement includes prohibitions on incurring debt, it is likely that it will also include prohibitions on guaranteeing or assuming debt. Therefore, more commonly, the fund will enter into an equity commitment letter with the lender pursuant to which the fund will agree to subscribe to equity in the NAV SPV if required to enable it to service its debt obligations.[160] Unlike equity commitments letters entered into with respect to acquisitions at the behest of sellers, a lender will always require a direct enforcement right against the fund. The NAV SPV structure is shown in Figure 2, and for all intents and purposes, the debt incurred by the NAV SPV is indirect fund-level debt, since the fund is ultimately responsible for the repayment of the principal and interest.

Once the NAV SPV has been incorporated, the fund's shares in the holding companies (topcos[161]) of each of the portfolio investments will typically be transferred to the NAV SPV, thereby interposing the NAV SPV between the fund and all of its topco holding entities.[162] The NAV Debt therefore sits above the umbrella of portfolio company silos and the NAV SPV becomes a holding company for all of the fund's interests. Although, the constitutional documents and stockholders' agreements of the topcos

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152 Morgan Lewis, *Accommodating Tax-Exempt Investors*, *supra* note 32.
153 *Id*.
154 *Id*.
155 *Supra* note 33, and accompanying text.
156 For specific U.S. tax-exempt investors, there may be other tax, reputational or regulatory reasons for avoiding investment through an offshore corporate blocker entity.
157 Fontenay & Nili, *supra* note 109, at 948.
158 Kerfoot & Joo, *supra* note 13; Loyens & Loeff, *supra* note 132.
159 Kerfoot & Joo, *id*.; Lynch & Texeira, *supra* note 74.
160 Kerfoot & Joo, *id*.
161 *See* text accompanying *supra* notes 77-80.
162 Kerfoot & Joo, *supra* note 13. Dworkin & Hait, *supra* note 12, at 102 (noting that, NAV Debt provided to funds-of-funds, commonly utilizes a second SPV, wholly-owned by the first borrower NAV SPV, to hold the equity in the topcos).

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may include various transfer restrictions on topco shares held by the fund,[163] transfers to entities under the

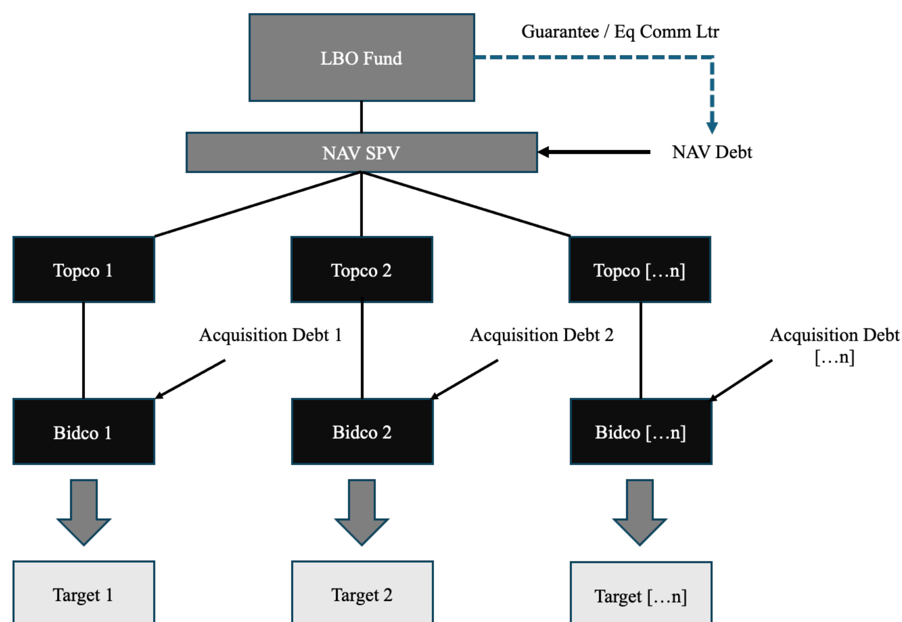

Figure 2: NAV Debt Borrowing Structure

common control of the fund are usually excluded from such restrictions. Since the NAV SPV is wholly-owned by the fund, such transfer restrictions will likely not be triggered by the transfer of topco shares to the NAV SPV, although the position has to be considered more carefully in relation to collateral as discussed below.[164] The NAV SPV, being further up the chain and further from portfolio company assets, than the bidcos (and midcos) which have incurred acquisition debt,[165] leads to the NAV Debt being structurally subordinated to the acquisition debt for each portfolio company.[166] Upon any of the portfolio companies becoming distressed, the acquisition debt for that portfolio company will have to be paid-off first before any of the assets of that portfolio company can be used to make payments under the NAV Debt.

Even where there are no fund-level prohibitions to the incurrence of debt, a NAV SPV structure may still be preferable where the fund has invested in portfolio companies through a parallel fund structure. Parallel funds are sometimes used for regulatory reasons instead of feeder funds - different types of investors invest through separate funds which are managed and invest on the same basis as each other, and each of which is structured tax beneficially for the relevant investors.[167] With such a

[163] Loyens & Loeff, *supra* note 132.
[164] *See* text accompanying *infra* notes 184-188.
[165] In relation to bidco and midco borrowings, see *supra* notes 80 and 85, and accompanying text.
[166] Lynch & Texeira, *supra* note 74.
[167] Kay, *supra* note 50, at 43; Kalajian *supra* note 33, at 7-8.

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structure, NAV Debt directly at the fund-level would require multiple fund borrowers, and a NAV SPV structure simplifies the financing to a single primary borrower.[168]

C. *Collateral*

NAV Debt is usually secured,[169] but private equity is nothing if not complicated, and the same holds true when attempting to secure NAV Debt. Ideologically, given that NAV Debt is lent against the net asset value of the portfolio companies of the fund, security should consist of the assets of those portfolio companies. However, as aforementioned, the NAV Debt is structurally subordinated to the acquisition debt for each portfolio company.[170] The acquisition finance facilities will inevitably include "negative pledge" provisions which prohibit the portfolio companies from pledging their assets as security for other debt.[171] Therefore, in a blow to simplicity, upon a breach of the NAV Debt, NAV Debt lenders cannot directly enforce against the assets of the fund's portfolio companies.

If a NAV Debt lender cannot get close to the underlying assets, surely the next step is to go further up the chain. Indeed, with portfolio company assets out of the collateral picture, such lenders seek to procure security over the shares of the companies holding the portfolio investments.[172] If possible, the fund or the NAV SPV, as the case may be, will pledge the shares it owns in each of the topcos to the NAV Debt lender.[173] With a NAV SPV structure, the lender will also likely attempt to obtain security over the shares in the NAV SPV held by the fund.[174] Three complications make such security problematical to implement in practice.[175] First, change of control provisions may pervade the downstream documents.[176] At the very least, the acquisition finance documents will include provisions that require the debt to be paid back in full if the majority ownership of topco changes.[177] Therefore, upon enforcement of the security over the shares of each topco by the NAV Debt lender, and transfer of ownership of the topcos to the lender, all the acquisition finance facilities lower down the chain could become repayable. Obtaining consent from acquisition debt lenders prior to perfecting the security is time-consuming and costly, particularly if that debt has been syndicated to multiple lenders.[178] Some commentators have suggested that NAV lenders could take the risk of those change of control clauses

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[168] Joe Robinson, *NAV Financings – Key Tax and Structure Considerations*, MACFARLANES In DEPTH (October 11, 2023).
[169] Bazar et al., *supra* note 136; and Lynch & Texeira, *supra* note 74 (however, noting that some established sponsors of funds owning high-quality assets may be able to obtain unsecured NAV Debt).
[170] *Supra* note 166, and accompanying text.
[171] Hutchinson & Lawrence, *supra* note 81, at 104; Kerfoot & Joo, *supra* note 13.
[172] Lynch & Texeira, *supra* note 74; Bazar et al., *supra* note 136.
[173] *Id.*
[174] Loyens & Loeff, *id.*
[175] A fourth issue may pertain relating to tax consequences, which will depend upon the domiciliation of the fund and its feeder or parallel funds, the tax residency of its limited partners, and the jurisdictions of incorporation of its portfolio investments. The relevant tax issues are beyond the scope of this article, but in certain circumstances, if a fund's acquisition structure has not been tax-optimized, the pledge of an equity interest in a controlled foreign corporation could be considered to be a repatriation to the U.S. of that corporation's earnings, resulting in a deemed distribution having been made to the fund (Bazar et al., supra note 136).
[176] Lynch & Texeira, *supra* note 74; Bazar et al., *supra* note 136.
[177] *Id.*; Loyens & Loeff, *supra* note 132.
[178] Loyens & Loeff, *id.* COOKE, *supra* note 130, at 262 (noting that if acquisition debt has been underwritten by a bank, it is likely that the bank will syndicate the debt to satisfy capital adequacy requirements and risk diversification).

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and obtain consent from acquisition finance lenders after the event if the security has to be enforced,[179] but any well-drafted change of control clause in the downstream acquisition documents will likely also include that the mere action of pledging shares in topco to a third party will be deemed to be a change of control.[180] Furthermore, change of control provisions may well be prevalent in commercial contracts of the portfolio companies.[181] The diligence exercise in such a case for the NAV Debt lender would be impractically extensive, involving a process akin to the diligence carried out by the fund on each and every portfolio company when it was acquired. The NAV Debt lender would also be hesitant to rely upon representations and warranties from the fund that change of control clauses do not invalidate or compromise the security, since to the extent that those representations and warranties are untrue, it would only likely come to light at a time when the fund is in default of the NAV Debt, with compensation for breach of those representations and warranties requiring enforcement of the same security – a circular conundrum.

A second material issue, even if the parties were to find a way around change of control impediments, is that if the NAV Debt lender is a bank, the lender will not see enforcement of security over shares as an attractive solution. Banks are not in the business of owning and operating (non-financial) commercial companies. The situation is distinct from acquisition financing where banks regularly procure security over the shares of bidco or the portfolio company.[182] In those cases, if the security must be enforced upon a default of the acquisition debt, the portfolio company is likely insolvent. Rather than continuing to own the business after enforcement, the bank will quickly appoint a trustee in bankruptcy with a view to selling the assets of the portfolio company and applying the proceeds to pay off the debt in a distressed sale. With NAV Debt, an event of default under the debt does not necessarily indicate that all the portfolio companies owned by the fund are distressed. The bank could easily end up becoming the owner of a healthy business. Although the bank could find an acquiror, the market for private companies is not liquid and an auction could take a material length of time. In fact, some banks may be prohibited under their own internal regulations to own majority equity interests in commercial businesses for long periods in this manner. The bleakness of the security position is lifted where the lender is a private credit fund. Private credit funds are structured in a similar manner to private equity buyout funds, and many private equity firms operate private credit and buyout funds.[183] A private credit fund will have little hesitation enforcing security over equity and it will often have the internal resources and expertise within the firm to own, operate and sell commercial businesses.

The third issue revolves around the equity documents of the various topcos. The constitutional documents and stockholders' agreements of those companies will include minority investor protections

[179] Loyens & Loeff, *id*.
[180] Lynch & Texeira, *supra* note 74.
[181] Bazar et al., *supra* note 136.
[182] Hutchinson & Lawrence, *supra* note 81, at 107; Skinner *supra* note 77, at 210.
[183] Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315, 343 (2017).

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in favor of portfolio company managers in their capacities as topco shareholders.[184] Those managers will have become equity owners in the topcos as part of the LBO model that ensures managers are heavily incentivized by equity ownership, and that they have substantive skin-in-the-game.[185] However, managers will seek contractual protections to prevent them involuntarily becoming beholden to a new master upon a change in the majority owner of topco equity. Although pure transfer restrictions on the fund's interests in the topcos are rare, managers may have tag-along rights allowing them to force an acquiror of a majority of shares to acquire their shares at the same price.[186] It is unlikely that a pledge of shares would trigger tag-along rights, but upon enforcement of the security, the lender would have to be prepared to acquire the managers' shares pursuant to the operation of the tag-along rights. If the fund already contemplates the possibility of NAV Debt at the time of the portfolio company acquisition, it can carve-out such enforcement rights from tag-along rights in the topco equity documents, but that may not be the case with older acquisitions when NAV Debt was not so widespread. Another wrinkle is also apparent if a particular acquisition is a "club deal" with one or more other private equity firms also providing equity capital for the acquisition.[187] In such a case, it is more likely that there will be transfer and pledge restrictions on each firm's equity interest in topco, and at the very least transfer pre-emption rights, meaning that the other firm or firms would have rights of first refusal to acquire the exiting fund's equity interests at the same "price" when the NAV Debt lender attempts to enforce its security.[188] For a bank, that may not be a bad outcome, since it will receive cash proceeds to pay down the debt, but difficulties may emerge in establishing the price that the other firms are required to pay for topco equity under the pre-emption rights.

What is left to secure? The answer is distributions from the underlying assets. The NAV Debt lender will have security over any of the NAV SPV's and fund's rights to distributions from underlying portfolio companies.[189] Furthermore, the NAV SPV and the funds will be required to place any distributions from portfolio companies into a ring-fenced account that will be pledged to the NAV Debt lender.[190] The fund will not be entitled to access that account to make onward distributions to limited partners (or to extract fees such as the carry) unless the "borrowing base" is satisfied – effectively distributions cannot be made unless the NAV Debt's LTV remains at or above the level on which the credit was extended.[191] LTV thresholds are discussed in the next sub-section.[192]

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[184] Loyens & Loeff, *supra* note 132.
[185] *See* text accompanying *supra* notes 121-123.
[186] Loyens & Loeff, *supra* note 132.
[187] Jenkinson et al, *supra* note 27, at 12.
[188] Ana Andreiana, *Club Deals: The Essentials of Structuring Co-Investments Via Luxembourg Vehicles*, LOYENS & LOEFF INSIGHTS (January 11, 2022) https://www.loyensloeff.com/insights/news--events/news/club-deals-the-essentials-of-structuring-co-investments-via-luxembourg-vehicles/
[189] Lynch & Texeira, *supra* note 74; Loyens & Loeff, *supra* note 132; Bazar et al., *supra* note 136; Casamento, *supra* note 136.
[190] *Id*.
[191] Bazar et al., *supra* note 136; Dworkin & Hait, *supra* note 12, at 101 (describing the "borrowing base"). Also, *see* text accompanying *infra* notes 195-196.
[192] *See infra* "*Financial Covenants and Interest*".

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Even if lenders are able to procure security over the fund's or NAV SPV's interests in topcos, they will also insist on security over distributions. Both rules of the traditional private equity LBO model are therefore broken – debt is no longer siloed between investments, and the fund now has liabilities, with the sacrosanct flow of distributions between the fund and limited partners now encumbered by a pledge in favor of the NAV Debt lender.

D. *Financial Covenants and Interest*

As with any finance facility, financial covenants will be included in the NAV Debt documents, a breach of which will require the fund to pay back the entire sum of the debt. The principle financial covenant in a NAV Debt package will be an LTV threshold, specifying that the LTV cannot fall below a certain level.[193] Any default may be curable (within a limited period of time) by paying down some of the debt to bring the LTV back below the threshold.[194] Therefore, if, for example, the value of portfolio companies were to decline through poor performance or upon a deterioration in general economic conditions, to the extent that LTV falls below the threshold, the fund would have a period of time within which to cure the default by either drawing further capital contributions from its limited partners (if there are uncalled commitments outstanding) or by selling portfolio investments and using the proceeds to pay down debt.

If a portfolio company or any of its material assets or subsidiaries is divested, part of the proceeds will be required to pay down some of the NAV debt to return the LTV to its original level, since the net asset value on which the debt was based will be reduced if the proceeds were otherwise distributed to limited partners.[195] Additionally, even where net asset value is not reduced, a "cash-sweep" mechanic may be employed, pursuant to which windfall distributions (such as dividends from highly performing portfolio companies) may be required to pay down some of the NAV Debt.[196]

While portfolio company distributions could be caught within cash-sweep provisions, it is unlikely that such distributions will be regular or predictable. Not only will much of the cash-flow at the portfolio company level be required to service the interest on acquisition debt, the acquisition finance documents may themselves include cash-sweep provisions[197] or restrictions on the level and regularity of distributions portfolio companies can make up the chain to the fund. A lack of a reliable cash-flow at the fund level presents a problem when it comes to paying interest on the NAV Debt. The customary solution is to capitalize interest so that no cash interest is regularly payable, but, instead, interest is added to the principal (and interest is payable going forward on the increased principal), and

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[193] Leung & Balasubramanian, *supra* note 11; Loyens & Loeff, *supra* note 132.
[194] Dworkin & Hait, *supra* note 12, at 101, 104.
[195] Robin Blumenthal, *NAV Finance: "A Huge and Growing Area"*, PRIVATE DEBT INVESTOR (February 2, 2023), available at https://www.privatedebtinvestor.com/nav-finance-a-huge-and-growing-area/; Lynch & Texeira, *supra* note 74.
[196] Lynch & Texeira, *id.*; Bowen et al., *supra* note 131. Jenkinson et al, *supra* note 27, at 30 (by analogy to cash-sweep provisions in acquisition debt).
[197] Jenkinson et al, *supra* note 27, at 30.

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payable at the end of the term of the NAV Debt facility or when payments must be made pursuant to cash-sweeps and LTV thresholds.[198] Often a "payment-in-kind" (PIK) mechanic is utilized, where PIK securities are issued with principals equal to the interest sums, and interest payable upon the principals of the PIK securities going forward.[199] The interest rate may be fixed or floating tied to a standard interbank base rate.[200] Even when otherwise a "fixed" rate, the NAV Debt package may also provide that the interest rate fluctuates based upon the LTV, with a higher LTV inuring a higher interest rate and *vice versa*.[201] The interest rate would thereby reflect the varying risk to the lender (known as an interest "margin ratchet").

NAV Debt clearly has several *sui generis* features, but it is also difficult to generalize the terms of the finance. It should be noted that there are, as of yet, no standard terms. Bespoke terms are negotiated with individual funds, and, with NAV Debt only recently becoming mainstream, it is a continually evolving asset class. However, the uses of NAV Debt are becoming well-known in the industry, to which we turn to next.

IV. THE USE OF NAV DEBT PROCEEDS AND THE BENEFITS TO LBO FUNDS

Having incurred NAV Debt, the next part of the story is how funds are using the cash drawn down. The uses are wide-ranging, and in this Part IV I classify those uses into three broad categories – offensive, defensive and liquidity - and outline their conceptual benefits.

A. *Offensive NAV Debt*

"Offensive" NAV Debt is used for proactive or opportunistic purposes to make further investments on behalf of the fund.[202] The relevant investment could be the acquisition of a new portfolio company,[203] or a "bolt-on" investment,[204] where an existing portfolio company requires further funding to acquire another business or subsidiary.

NAV Debt could also be used in an offensive manner to refinance existing acquisition debt facilities.[205] It has been noted that with exit values depressed,[206] vintage private equity funds are finding

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[198] Louch et al., *supra* note 16.
[199] *Id*.
[200] Bucak, *supra* note 18 (suggesting that floating rate NAV Debt interest is more common); Louch et al., *supra* note 16 (same); Blumenthal, *supra* note 195 (same).
[201] Bowen et al., *supra* note 131.
[202] Dworkin & Hait, *supra* note 12, at 103 (noting the emergence of escrow accounts to hold loan proceeds under the NAV Debt facility until utilization, with a condition that such proceeds can only be released to complete the specific investment for which the sums are being lent).
[203] Kerfoot & Joo, *supra* note 13.
[204] Leung & Balasubramanian, *supra* note 11; Loyens & Loeff, *supra* note 132; Robinson, *supra* note 168. McElhaney, *supra* note 20 (suggesting that bolt-ons are the most common use case for NAV Debt).
[205] Lynch & Texeira, *supra* note 74; Doyle, *supra* note 144.
[206] *Infra* notes 241-242 and 248-250, and accompanying text.

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it challenging to divest of investments at a satisfactory price prior to the maturity of the portfolio company-level debt used to acquire the relevant company.[207] The average investment holding period for U.S. and Canadian private equity buyout funds divesting of portfolio companies in 2023 soared to 7.1 years from 5.7 years in 2022.[208] In 2010, the average was only 3.8 years.[209] Longer holding periods will start to bump-up against maturity terms for acquisition finance – usually in the region of 5-7 years.[210] If exit values are low, it becomes more beneficial for the fund to refinance the acquisition debt rather than selling the investments. Reverting to the rational for debt analogy discussed earlier,[211] leveraging an investment can enhance returns, if the fund exits an investment at a profit, but the reverse is true when the fund makes losses.[212] By way of example, if a fund acquires a portfolio company for $500m using 50% debt, but the company is worth only $300m at the time when the debt matures, the loss on investment is 80%. If the acquisition had been debt-free, a sale at that price would have resulted in a loss of 40%. Rather than "re-up'ing" the acquisition finance with the same lenders, NAV Debt can be incurred at the fund-level and contributed down the chain to the portfolio company to pay-off the maturing acquisition debt.[213] Debt at the portfolio company-level is effectively replaced by debt at the fund-level.

Offensive NAV Debt presents several conceptual benefits to a fund. One benefit is that although NAV Debt is not "cheap", for a private equity firm with a strong reputation, high quality investments, an ability to offer a robust security package, and willing to borrow at a low LTV, a lower interest rate may be attainable at the fund-level than at the portfolio company-level, since the borrowing will be against assets of higher value with greater diversity.[214] Most obviously, this will assist funds when seeking to refinance existing acquisition debt,[215] particularly with the trend in interest rates in recent years. Between 2009 and 2016, interest rates were historically low at near-zero rates.[216] After a short period of rising interest rates to just over 2% in 2019, the federal-funds rate fell to near-zero once again in 2020 with the onset of the pandemic, before a rapid surge in response to rising inflation, reaching 5.5% in July 2023.[217] Accordingly, when the relevant portfolio company was acquired, interest rates will have been far lower and the discounted cash-flow basis on which the portfolio company was valued

[207] Antoine Gara & Eric Platt, *Private Equity: Higher Rates Start to Pummel Dealmakers*, FINANCIAL TIMES (November 1, 2023), https://www.ft.com/content/8b4a5df6-7f6d-480f-8d20-55793854c37e; McElhaney, *supra* note 20.
[208] Karl Vidal & Annie Sabater, *Private Equity Buyout Funds Show Longest Holding Periods in 2 Decades*, S&P GLOBAL MARKET INTELLIGENCE (November 22, 2023) https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/private-equity-buyout-funds-show-longest-holding-periods-in-2-decades-79033309
[209] Financier Worldwide, *supra* note 21.
[210] Hutchinson & Lawrence, *supra* note 81, at 89; Gara & Platt, *supra* note 207.
[211] *See* Part I(C) of this article.
[212] Rasmussen, *supra* note 24; Fontenay & Nili, *supra* note 109, 923 n.74.
[213] Gara & Platt, *supra* note 207.
[214] Kerfoot & Joo, *supra* note 13; Lightbrown, *supra* note 18. Louch et al., *supra* note 16 (noting that the current economic climate means that "refinancing at the individual asset's level is more expensive and difficult"). Bucak, *supra* note 18 (however, noting that interest on NAV Debt has gone as high as 20%).
[215] Financier Worldwide, *supra* note 21.
[216] Nick Timiraos, *Fed to Signal it has Stomach to Keep Rates High for Longer*, THE WALL STREET JOURNAL (April 30, 2024) https://www.wsj.com/economy/central-banking/federal-reserve-meeting-interest-rates-inflation-6dcb05e8).
[217] *Id.*

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at acquisition will have been based upon interest rates prevalent in the market at the time.[218] The shock of refinancing at a much higher rate will eat into the returns that had been anticipated at the time of acquisition. NAV Debt could potentially dampen that shock. Similarly, using NAV Debt for new portfolio company acquisitions or bolt-on investments could result in interest cost savings for funds. With respect to bolt-on investments, one may query why a fund would not simply enter into negotiations with the existing acquisition finance lenders to lend further finance to the portfolio company on the same terms? However, in such circumstances, it is likely that the lender will request that the entire acquisition debt is refinanced on terms more favorable to the lender, at a time when the existing value of that debt will have fallen in real terms with the increase in market interest rates. NAV Debt facilitates a smaller borrowing without prejudicing the terms of the existing acquisition lending.

A shortage of LBO debt in the market could also precipitate the use of NAV Debt to make acquisitions. Reports have suggested that traditional banks have suffered record losses on debt commitments in recent times after lending at low interest rates prior to the increase in rates in 2021 and 2022.[219] It has also been challenging for those banks to syndicate those loans leading to them becoming stuck on their balance sheets, making them reluctant to re-enter the risky LBO market.[220] Funds could tap the more costly private credit market for acquisition debt,[221] but another, cheaper, option for a fund is to borrow NAV Debt from traditional banks, who may be more willing to lend to a fund at low LTV backed-up by all of the fund's assets[222] – the less risky nature of the debt will make it easier to syndicate.

NAV Debt also gives funds the opportunity to take advantage of "dislocated" asset prices at a time of significant economic shocks.[223] During such periods, the price of assets may be disproportionately impacted by short-term economic, political or social events, dislocating them from their longer term value when those shocks abate.[224] Lenders may not be prepared to lend at the portfolio company-level in the face of such volatility, or at least not at a cost that is sustainable for the investment's cash-flow. NAV Debt comes to the rescue to enable such acquisitions to be completed, and for the fund to benefit from discounted acquisition values. Furthermore, if the NAV Debt implements PIK interest (which may be the case if used for bolt-on investments), it can be particularly beneficial for growing any bolt-on business acquired – cash-flow could be utilized for growth rather

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[218] Bobby V. Reddy, *Deconstructing Private Equity Buyout Valuations*, 8 J. BUS. L. 629, 642, 645, 647 (2022) (discussing the discounted cash-flow basis of private equity acquisitions, and how a lower interest rate at the time of an LBO acquisition would decrease the level of discount applied to the predicted cash-flow of the target on which value is based, as well as increasing the terminal value of the target, further increasing the overall valuation of the target).
[219] Jill R. Shah and David Scigliuzzo, *Debt Losses for Buyouts Top $1 Billion and Banks Brace for More*, BLOOMBERG (July 19, 2022), https://www.bloomberg.com/news/articles/2022-07-19/debt-losses-for-buyouts-top-1-billion-and-banks-brace-for-more
[220] Stephen Gandel et al., *Big Banks Sit Out LBO Rebound After Being Stung by Earlier Buyouts*, FINANCIAL TIMES (October 8, 2023), https://www.ft.com/content/8962a5cc-2c4c-4e18-801c-9ad4e342f1fd
[221] *Id*.
[222] Kerfoot & Joo, *supra* note 13.
[223] Gara & Platt, *supra* note 207; Lynch & Texeira, *supra* note 74.
[224] Paolo Pasquariello, *Financial Market Dislocations*, 27 REV. FIN. STUD. 1868, 1868 (2014).

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than to service regular interest payments that would otherwise be payable if the investment were made by extending the existing acquisition debt.[225]

NAV Debt may also be used on acquisitions and bolt-on investments instead of, or supplementing, limited partner capital commitments.[226] In such cases, the relevant acquisition will be completed partly with acquisition debt at the portfolio company-level, and partly with NAV Debt constituting the equity component of the transaction. Why would the fund take such an approach? Two reasons pertain depending upon the time scale. Some funds are permitted to make investments outside their investment periods, but are only permitted to drawdown on capital commitments from limited partners during that investment phase.[227] Accordingly, NAV Debt may be used by a fund to acquire a handful of further investments toward the end of the life of the fund to enhance returns.[228] Taking advantage of dislocated asset values will of course drive such behavior. Additionally, a fund may use NAV Debt during its investment period even when it has undrawn commitments from limited partners. In such cases, NAV Debt begins to resemble subscription facilities, but with the distinction that the debt will not be paid back upon a subsequent drawdown from limited partners. Delaying drawdown from limited partners can improve the financial metrics of the fund, since the shorter the period that investor capital is at risk before exit returns are distributed, the higher the internal rate of return (IRR) for those limited partners.[229] This can be particularly beneficial for a private equity firm if the performance of that fund is being assessed by those limited partners at a time when they are considering investing in a new fund proposed to be established by the firm. The higher IRR may give the firm a more favorable outlook in the eyes of limited partners when they are determining whether to back a successor fund.[230] Further, as discussed below, if the carry and hurdle rate is calculated based upon IRR, such as approach allows the general partner to accelerate the receipt of its carry.[231]

B. *Defensive NAV Debt*

In contrast to offensive NAV Debt, "defensive" NAV Debt is reactionary. The borrowing of NAV Debt is in response to underperforming portfolio companies.[232] Certain companies within the fund's portfolio may be struggling financially, or even in breach of covenants under their relevant acquisition finance documents. NAV Debt can be used to prop-up such companies, and, to the extent permitted

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[225] While PIK interest may be implemented for offensive NAD Debt to make bolt-on investments, NAV Debt utilized to acquire a fresh portfolio company will likely employ cash interest, since there will be no underlying acquisition debt restricting distributions to pay interest on the NAV Debt.
[226] Lynch & Texeira, *supra* note 74; Loyens & Loeff, *supra* note 132.
[227] *Id*.
[228] Lynch & Texeira, *supra* note 74.
[229] Jenkinson, *supra* note 27, at 14; Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSP. 147, 162 (2009).
[230] Also, *see* text accompanying *infra* notes 326-329.
[231] *See* text accompanying *infra* note 330.
[232] Loyens & Loeff, *supra* note 132; Lynch & Texeira, *supra* note 74 (describing defensive NAV Debt as "principal-protecting").

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under the acquisition finance documents, cure the relevant default under the underlying debt.[233] The NAV Debt would need to be contributed down the chain as equity contributions, with each SPV in the chain subscribing to stock in the SPV lower down, until the cash reaches the primary borrower or the portfolio company.[234] As equity, the contributions are therefore legally subordinated to the underlying acquisition debt, which will be required under the facility documents.

Additionally, although acquisition debt refinancings were cast in terms of offensive NAV Debt above,[235] it would appear that most NAV Debt refinancings are as a result of portfolio companies failing to pay interest on acquisition debt, and, therefore, more defensive in nature.[236] For a portfolio company struggling to generate sufficient cash-flow to satisfy regular interest payments, the replacement of the acquisition debt with fund-level, PIK interest-incurring NAV Debt may be a lifesaver.[237]

Defensive NAV Debt can benefit the fund as a whole if a portfolio company is merely suffering due to temporary economic conditions. If the private equity firm genuinely believes it is possible to turn around the company, the debt enables it to rescue the company from a potential bankruptcy and bet upon its performance improving over the longer term and creating returns for the fund. Outside the fund's investment period, it cannot draw-down on commitments from limited partners to bolster such companies, and NAV Debt therefore obviates the general partner itself having to risk its own capital to finance the rescue.

C. *Liquidity NAV Debt*

Liquidity NAV Debt is neither proactive nor reactive, but is arguably the most controversial use of such finance. Liquidity NAV Debt involves the fund using the cash borrowed simply to make distributions and return capital to limited partners.[238]

It is not uncommon for the distribution, or part of the distribution, to be recallable by the fund's general partner from the limited partners if certain conditions apply, including strict requirements as for what any recalled distributions can be used and the period for which the distribution remains recallable.[239] Although "recallable provisions" do suffuse the market, it appears that it is unusual for such recalls to be triggered by general partners in practice.[240]

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[233] Lynch & Texeira, *id*.
[234] The underlying acquisition facility documents will not permit the NAV Debt to be contributed down the chain as debt, since there will be restrictions on the incurrence of further debt by topco, midco, bidco and the relevant portfolio companies without acquisition debt lender consent.
[235] *Supra* note 205, and accompanying text.
[236] Gara & Platt, *supra* note 207.
[237] *Id*.
[238] Kerfoot & Joo, *supra* note 13; Lynch & Texeira, *supra* note 74; Robinson, *supra* note 168.
[239] Adam Le & Alex Lynn, *Recallable NAV Loans: The "Zero-Sum Game" Leaving LPs in a Bind*, PRIVATE EQUITY INTERNATIONAL (November 2, 2023), available at https://www.privateequityinternational.com/recallable-nav-loans-the-zero-sum-game-leaving-lps-in-a-bind/
[240] *Id*.

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Liquidity NAV Debt has only become a conventional technique in recent years, and its use and long-term consequences may not yet be fully understood. However, it appears that the contemporary driver for liquidity NAV Debt stems from a moribund exits market.[241] 2022 and 2023 saw precipitous declines in private equity exits, with 2023 being the worst year for U.S. private equity exits by value in at least a decade.[242] Consultancy firm, Bain & Co., has described how buyout firms have a "towering backlog" of companies to exit.[243] A historically low interest rate environment will have pervaded the acquisitions made by most extant vintage LBO funds which are now seeking to exit their investments.[244] The discounted cash-flow valuation basis on which those portfolio companies were acquired would have reflected low costs of debt leading to private equity acquirors willing to pay higher purchase prices without prejudicing the making of returns at least above the hurdle rate.[245] The unforeseen uptick in interest rates in recent years will have obliterated those historic valuations.[246] In a higher interest rate environment, potential acquirors, especially those using, now costly, debt financing (such as other private equity firms in secondary buyouts), are valuing companies more conservatively.[247] As of the end of the first quarter of 2024, U.S. private equity exit values stood at 22.7% of pre-pandemic levels, and at a huge discount of 75% to peak quarterly exit value in 2021.[248] A standoff or "logjam"[249] has developed, with a disconnect between private equity sellers seeking to crystalize investments and buyers willing to acquire them, exacerbated by the surge in deal volume in 2021 and early 2022.[250] The issue becomes particularly pertinent when the fund is nearing the end of its lifetime so under pressure to exit investments pending dissolution of the fund.[251]

As the co-founder of W Capital recently expressed, "There are 28,000 private-equity-backed companies. There's no way that current inventory is going to exit within the next 10 years. GPs are right at the tipping point of having to rethink 'when am I going to create liquidity for my funds?' because they can't wait for the IPO market and they can't wait for the strategic M&A market."[252] Either private equity funds have to take the hit on returns and sell at a discounted price, or find a way to ride-out the period in the expectation that valuations will increase once more when interest rates fall.

Several mechanisms have developed in the market to tide funds over during the current economic strife. Continuation funds are one method - the private equity firm establishes another fund purely to

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[241] Financier Worldwide, *supra* note 21; Gara & Platt, *supra* note 207.
[242] Pitchbook, *US PE Breakdown*, Q1 2024 1, 21 (April 9, 2024) (showing 2024 being on track to match 2023); Gara & Platt, *supra* note 207; Louch et al., *supra* note 16.
[243] Gara & Platt, *supra* note 207.
[244] *Supra* notes 216-218, and accompanying text.
[245] *Supra* note 218; Gara & Platt, *supra* note 207.
[246] *Supra* notes 216-218, and accompanying text.
[247] Matt Wirz, *Funds Depose Banks as Wall Street Kings*, THE WALL STREET JOURNAL, A1-A2 (April 22, 2024). Financier Worldwide, *supra* note 21 (noting that the median enterprise value for U.S. and European PE buyouts in the first quarter of 2023 was 1.7 times revenue, down from 2.4 in 2022).
[248] Pitchbook, *supra* note 242, at 21.
[249] *Id*., at 4.
[250] *Id*., at 21.
[251] *Supra* note 42, and accompanying text.
[252] David Wachter, as quoted in Rod James, *AXA Division Wagers On Private-Equity Shift*, THE WALL STREET JOURNAL, B1-B2 (April 4, 2024).

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acquire a portfolio company from, or a "strip" of partial interests across the portfolio of, the original fund, permitting limited partners to exit or roll-over into limited partner interests in the new fund.[253] The holding period for the relevant portfolio company or companies can therefore be extended until the environment for exits improves. Another option is to simply extend the lifetime of the original fund. As discussed, the fund's term can usually be extended in the sole discretion of the general partner for two or three years, and even longer with limited partner consent.[254] If the general partner can persuade limited partners that the fund is leaving cash on the table by being forced into an artificially imposed exit when valuations are depressed, limited partners may indeed be prepared to extend the lifetime of the fund.

However, limited partners will have made their investments in the fund on the basis of receiving returns well within ten years.[255] An extended period without returns, especially if the fund is struggling to exit any of its portfolio, hammers the metrics on which limited partners have made their investments, and the general partner may feel under pressure to make distributions prior to the end of the fund.[256] NAV Debt allows the general partner to make a distribution to the limited partners detached from divestments of portfolio companies. A general partner may find it challenging to make the case to limited partners to extend the life of the fund without at least giving limited partners some returns on their investments.

NAV Debt therefore assists LBO funds in insulating investors from, what they will hope is a temporary, discounted portfolio company exit market, facilitating distributions without having to sell investments at bottom-of-the-market prices.[257] NAV Debt can also facilitate continuation fund structuring – if all limited partners in the original fund do not "roll-over" into the new fund,[258] NAV Debt at the continuation fund-level can provide a bridge to pay the original fund for the acquisition of the relevant portfolio company while the new continuation fund seeks new limited partners to provide capital.[259]

Even outside intents to extend the lifetime of the fund, a dearth in distributions can cause limited partners problems. Limited partners will have invested in funds based upon a cash-flow modelling system and therefore will not have made their investments based upon a lump sum distribution after the end of the life of the fund, but, instead, will have expected partial distributions throughout the exit

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[253] Kastiel & Nili, *supra* note 98, at 13, 18; Clifford Chance, *"Decoding" the Secondary Market*, THOUGHT LEADERSHIP (October 2019) https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2019/10/decoding-the-secondary-market.pdf
[254] *Supra* note 40, and accompanying text.
[255] *Infra* note 260, and accompanying text.
[256] Cheffins & Armour, *supra* note 42, at 14.
[257] Robinson, *supra* note 168. Note that if a European waterfall hurdle rate has already been satisfied, in the normal course, the general partner may in fact be incentivized to sell portfolio companies even though prices are depressed in order to accelerate the carry (David T. Robinson & Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUD. 2760, 2788 (2013). The availability of NAV Debt can moderate that pernicious incentive.
[258] *Supra* note 253, and accompanying text.
[259] Carroll, *supra* note 17; Leung & Balasubramanian, *supra* note 11; Loyens & Loeff, *supra* note 132.

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period of the fund.[260] Without those distributions, they may not be able to fund their other commitments, including uncalled capital commitments under other funds in which they are invested, and therefore forced to sell their fund interests (with general partner consent) in the secondaries market.[261] However, in what is a buyers' market, the discount rate on limited partner sales has surged in recent years, with one study finding that the discount on fund net asset value that buyers are applying to limited partner interests has risen from 3% in 2021 to 13% in 2022,[262] with some seeing discounts as large as 25%.[263] Liquidity NAV Debt gives limited partners the possibility of liquidity at par[264] without taking such a substantive hit to value in the secondaries market, while also preserving the opportunity to share in continued upside if exit values recover in the future.[265]

Two further benefits apply to liquidity NAV Debt from either side of the divide. For general partners, returning capital to limited partners allows the private equity cycle to keep turning. The cycle outlined in Figure 3a falls apart if a fund is not making exits. The limited partners in a private equity fund will have limits to their maximum exposure to private equity and will model their portfolio of investments on the basis of regular cash-flow distributions over time[266] - without regular distributions, such investors will not have the liquid capital to invest in new funds established by the general partner.[267] That is a significant blow to the private equity model, since with finite lifetime funds, the continuing generation of profits for the firm is dependent upon constantly establishing new funds.[268] It is no surprise that with a decline in exits, the number of U.S. private equity funds that have closed capital raisings dramatically declined in 2023.[269] Although total funds raised did tick upward in 2023,[270] it was concentrated within a handful of megacap funds, with limited partners consolidating what little cash they did have into blue-chip private equity.[271] Figure 3b shows how liquidity NAV Debt can distribute the cash to limited partners that they can then recycle into new funds.[272] Furthermore, in much the same way as delaying drawdowns from limited partners,[273] returning capital to limited partners can increase

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260 Jenkinson, *supra* note 27, at 14.
261 Cheffins & Armour, *supra* note 42, at 11 n.52; Magnuson, *supra* note 24, at 1879 (noting that general partner consent is required for limited partners to transfer their interests in the fund prior to the end of the fund's term).
262 Lightbrown, *supra* note 18.
263 Carroll, *supra* note 17.
264 Although lenders will not lend 100% of the net asset value of the fund, since there is no change in ownership of the assets and no negotiation of price between a buyer and seller, the limited partners effectively receive a distribution on their investment at no discount (other than the interest eventually payable on the NAV Debt) (*id.*).
265 *Id.*; Lightbrown, *supra* note 18.
266 *Supra* note 260, and accompanying text.
267 Stephenson & Jones, *supra* note 14 (noting the "denominator effect" which hinders investors from investing in new funds until they have received distributions from investments in existing funds).
268 Carroll, *supra* note 17; Pitchbook, *supra* note 242, at 21; Metrick & Yasuda, *supra* note 29, at 2304.
269 Pitchbook, *supra* note 242, at 28.
270 *Id.*
271 Chris Witkowsky, *Texas Teachers' PE Chief on Focus on DPI, Shift to Smaller Market Funds*, BUYOUTS (December 28, 2023), https://www.buyoutsinsider.com/texas-teachers-pe-chief-on-focus-on-dpi-shift-to-smaller-market-funds/#:~:text=The%20system%20has%20been%20focusing,team%20has%20grown%20to%2026.
272 Doyle, *supra* note 144 (noting how NAV Debt can support general partners in increasing commitments to future fund-raises).
273 *Supra* note 229, and accompanying text.

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IRR. The increase in IRR can improve the performance metrics of the current fund, thereby promoting the marketing of successor funds.

On the other side of the divide, the fund managers of limited partners may also see meaningful benefits from liquidity NAV Debt. Many fund managers are themselves compensated on an IRR basis. An extended period between making capital contributions and receiving returns, reduces IRR,

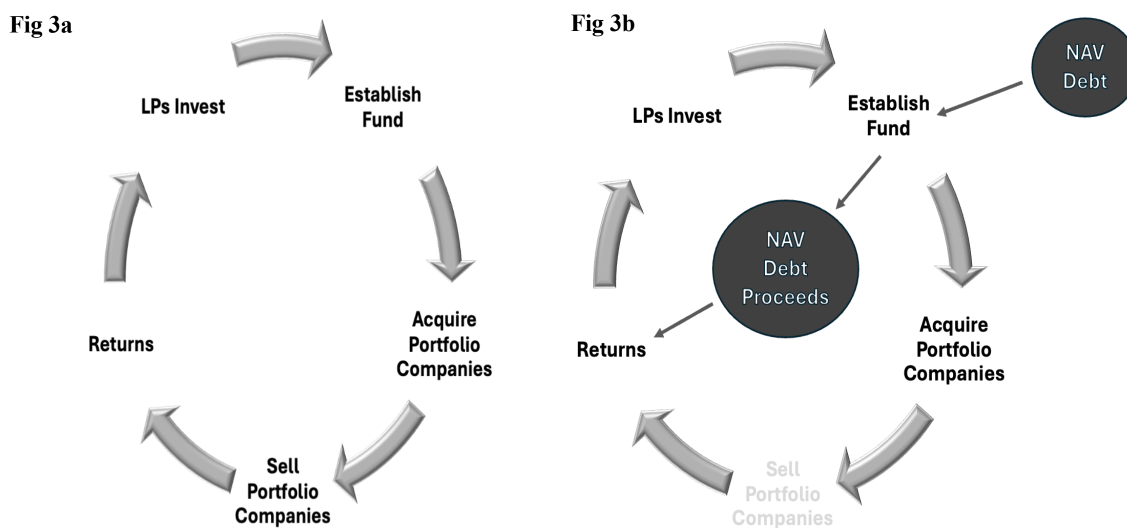

Figure 3: Private Equity LBO Lifecycle

potentially impairing their personal compensation. Liquidity NAV Debt in the face of a stagnant exits market may be rationally attractive for such fund managers.[274]

Whether offensive, defensive or liquidity, NAV Debt can be conceptually beneficial to funds, private equity firms and limited partners alike. NAV Debt can also present benefits to lenders. If lenders are able to secure a robust security package and do not overextend themselves over the net asset value of a fund's investments, NAV Debt is relatively low-risk lending that creates returns (including arrangement and commitment fees) at a time when the market for acquisition finance has declined.[275] The lending is fairly low-risk since if there is a default, there should be plenty of buffer within the net asset value of the portfolio companies to pay off the debt. As one specialist NAV lender put it when discussing the 91 investments his firm had made, the firm had "never lost money".[276] Conservative NAV Debt lending can be robust against significant economic shocks for a lender, and currently yields are between 10% and 12% on average.[277] Framed solely within that prism, NAV Debt would seem to

[274] ILPA, *Enhancing Transparency Around Subscription Lines of Credit*, 1, 4 (June 2020) (by analogy to the use of subscription facilities to increase IRR).
[275] Pitchbook, *supra* note 242, at 6 (showing the decline in private equity buyouts in 2022 and 2023).
[276] Quote from Pierre-Antoine de Selancy of 17Capital (Blumenthal, *supra* note 195).
[277] *Id* (noting that NAV Debt with a 20% LTV going into the 2008/9 financial crisis would have increased to no more than 30% during the downturn, returning to 20% by 2010). Also, *see infra* note 281.

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be an innovative and sophisticated adaptation to turbulent economic times revitalizing a dormant industry. However, in the next section, we will discuss the darker side of NAV Debt.

V. THE DETRIMENTS OF NAV DEBT

Notwithstanding the optimistic picture painted in Part IV, limited partners have expressed their concerns regarding the growing front of NAV Debt. One investor's senior investment officer stated, when discussing NAV Debt, "We've definitely communicated to our partners that we're not happy about it".[278] Why would limited partners question the utopia of NAV Debt? In this Part V, we delve into the traditional LBO fund and governance models described in Parts I and II, and canvass the bleaker consequences of NAV Debt.

A. *Contagion Risk*

One of the rules of private equity is the silo-ing of investments, such that if one investment fails, the acquisition debt lenders can only make claims against the assets of that portfolio company.[279] NAV Debt and its propensity to cross-collateralize assets across the fund changes the game. Cash-flow and divestment returns from the entire portfolio of the fund must be used to satisfy the NAV Debt at the fund-level. If one investment fails, the NAV Debt must still be satisfied by the entire portfolio, meaning that other, healthier assets within the portfolio must service a disproportionately large portion of the NAV Debt.[280] In effect, poor investments contaminate the entire portfolio. That contagion risk can occur even if an asset does not "fail" completely into insolvency.

Take for example a $1 billion NAV Debt loan, taken-out in July 2023, to an LBO fund with net asset value of $5 billion spread across ten portfolio companies each with net asset value of $500 million. The initial LTV was therefore 20%. Let's assume an LTV financial covenant threshold of 25%, and a (possibly conservative[281]) PIK interest rate of 10%. Even if the net asset value of the portfolio remains constant, with accrued (and compounded) PIK interest, by July 2025, the loan's principal is now $1.21 billion - an LTV of 24.2%, bumping-up against the LTV threshold.[282] However, consider circumstances where two portfolio companies performed poorly – although still sufficiently viable to pay acquisition debt interest and with positive net asset values. In a dramatic, but plausible, example, imagine that by July 2025 the net asset values of those two companies has each dropped 90% to $50 million (with the

[278] Witkowsky, *supra* note 10.
[279] *See* Part I(D) of this article.
[280] Bucak, *supra* note 18.
[281] Louch et al., *supra* note 16 (reporting that in 2023, NAV Debt interest terms were around 7% above benchmark rates, leading to minimum borrowing costs of *at least* 10% in the U.S., with some reaching as high as 20% or 30%). Also, *see* Bucak, *supra* note 18; *supra* note 277, and accompanying text.
[282] Since NAV Debt more commonly employs a floating rate of interest, this example assumes that the federal-funds rate has remained constant.

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other portfolio company net asset values remaining constant). LTV is now 29.5%, and the fund will be required under the relevant covenant to pay down some of the NAV Debt.[283] Selling the two poorly performing companies would generate $100 million, which would only bring the LTV down to 27.8%. Unless the fund can secure further funding, to pay down the NAV Debt further, it will need to divest of healthy companies that would otherwise have longer term growth potential.[284] NAV Debt may have been incurred to tide the fund over a period of poor exit values, but it could in certain circumstances compel the sale of assets at a discount.

The traditional private equity model has been carefully developed to avoid such contagion risk. The NAV Debt approach suggests that private equity firms are parking potential issues, gambling upon a turnaround in the economy before the NAV Debt becomes repayable. Taking defensive NAV Debt as an example, if NAV Debt is incurred to cure acquisition debt defaults or refinance such debt, in the current environment, that debt is likely costing far more than the acquisition debt originally incurred some years back. The struggling portfolio company went into default on the cheaper acquisition debt, so certainly can't service the more expensive NAV Debt. Other, healthier, portfolio companies may be expected to pick up the slack. To avoid NAV Debt simply being good money thrown after bad, the fortunes of the struggling company must eventually improve to not only be able to pay-off any remaining acquisition debt, but also to pay the extra accrued NAV Debt PIK interest.

Contagion-risk from NAV Debt could also change the dynamics of fund decision-making in innumerable unintended ways. For example, decisions may be made to exit healthy investments on the basis of performance elsewhere across the portfolio and the need to repay NAV Debt (or at least repay part of the debt if capitalized interest is becoming too costly) rather than on the basis of whether it is the optimum time to sell to maximize returns. Similarly, a fund may sit on a poorly performing asset rather than selling for fear that an exit will reveal a decline in net asset value breaching the LTV covenant threshold; since there is no liquid market for private companies, until a sale, a decline in the valuation of the portfolio company may have been obscured.[285] The unlimited liability of the general partner for the NAV Debt may also influence such behavior.[286] Although the general partner itself is usually a limited liability shell entity,[287] the firm's carry could be at risk and if the general partner were to ever become insolvent, it would be a considerable reputational hit for the firm. It is difficult to discern the overall outcome that a change in decision-making psychology will have on LBO returns, but it is clear that NAV Debt disturbs the traditional model.

B. *Private Benefit Motivations*

[283] *Supra* note 194, and accompanying text.
[284] Martinez, *supra* note 9; Gara & Platt, *supra* note 207.
[285] Witkowsky, *supra* note 10; Cheffins & Armour, *supra* note 42, at 14.
[286] *Supra* note 34, and accompanying text.
[287] *Supra* note 37, and accompanying text.

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The reasons private equity firms cause their funds to incur NAV Debt may not be quite so altruistic as the benefits outlined in Part IV seem to allude. Let's consider liquidity NAV Debt and its interaction with the carry. For a fund operating on a pure European waterfall model, a logjam in exits may forestall the receipt of carry. Even if the relevant fund has divested of a majority of its portfolio companies, it may not have returned all of the limited partners' capital and surpassed the hurdle rate. Alternatively, the hurdle rate may have already been exceeded, but the full extent of the carry cannot be realized until the remaining portfolio companies are sold. While limited partners, who have already at least received some liquidity from earlier sales, may be content to simply wait out an improvement in exit values for the sale of the remaining portfolio companies, the general partner may be more motivated to use liquidity NAV Debt to accelerate the payment, or further payment, of the carry.[288] A misalignment in the interests of the limited partners and the general partner exists in such a scenario. Saddling the fund with interest to pay on the NAV Debt (potentially at high rates) may not be in the interests of the limited partners, eating into final returns.[289]

The implementation of an American waterfall for carry determination, on the other hand, can create other incentives for the use of defensive NAV Debt. If toward the end of the lifetime of the fund, the remaining assets are performing adequately to service acquisition debt, but their values are not large enough to exceed the hurdle rate on those investments, rather than cutting its losses, the general partner may take a Hail Mary approach and incur offensive NAV Debt to cause those companies to make risky investments in an attempt to improve returns above the hurdle rate. Akin to the conflict apparent between shareholders and creditors in a failing corporation,[290] the general partner has nothing to lose by pouring more resources into the portfolio company in the hope of turning around the investment, instead of exiting or winding-up the investment sooner – the general partner will not receive a carry as it is, so taking actions that risk creating greater losses for the limited partners will not create any greater losses for the general partner.[291] However, for limited partners, the NAV Debt will reduce returns on those, and possibly other, investments further, potentially turning a positive return (albeit under the hurdle rate) to a negative return. Although such behavior may be constrained to a degree by the reputational consequences for the private equity firm in the investor fund-raising and debt markets,

[288] Eqvista, *supra* note 54 (noting that European waterfalls can incentivize general partners to take a short-term focus to ensure that the carry is paid as quicky as possible); First National, *supra* note 52 (same).
[289] Gara & Platt, *supra* note 207.
[290] Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 6 VAND. L. REV. 1485, 1489 (noting that upon insolvency, conflicts between shareholders and creditors of corporations are exacerbated, since shareholders, who would receive zero in bankruptcy proceedings, will, with nothing to lose, be more desirous of the company taking risks, whereas creditors will seek protection of assets to satisfy debt claims).
[291] Magnuson, *supra* note 24, at 1871, 1874 (2018).

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which could prejudice the success of future fund-raises or increase the costs of finance for successor fund investments,[292] the efficacy of such reputational constraints have been doubted in some quarters.[293]

The management fee can also be a driver behind the use of NAV Debt. Pertinently, one study found that management fees constitute approximately twice as much as carry fees earned by a private equity firm over the lifetime of a fund[294] - prioritizing maximization of the management fee (even over maximizing returns) may therefore be in the interests of a general partner.[295] As discussed in Part I, it is common for the management fee to shift after the investment period from a calculation based upon committed capital to remaining capital invested.[296] In the normal course, as assets are divested, the remaining capital invested falls, reducing the management fee received, but liquidity NAV Debt enables distributions to limited partners while delaying exits and squeezing the portfolio for continuing management fees.[297] A general partner may also be inclined to incur defensive NAV Debt to sustain a struggling portfolio company's service of acquisition debt interest payments, rather than taking the relevant company into bankruptcy and liquidating its value. The continued earning of a management fee may exceed the impact of the NAV Debt interest on the general partner's carry.

A further, more esoteric, private benefit that private equity firms may derive from the explosion of NAV Debt stems from the incestuous borrower-lender relationships that have developed over the last decade. While it is well-known that direct lending on LBOs is often provided by private credit funds, with large private equity firms often running both buyout and direct (unitranche) lending funds,[298] it is now becoming apparent that such private credit funds are also acting as NAV Debt lenders taking advantage of the high interest rate environment.[299] Conflicts of interest could arise. For instance, a NAV Debt lender to fund "A" could potentially be a buyout sponsor of fund "B" borrowing NAV Debt from the private credit fund of the buyout sponsor of fund "A". The funds could enter into a private arrangement, whereby fund A only agrees to borrow NAV Debt if fund B also borrows NAV Debt from the private credit fund of the sponsor of fund A? The rationale for a fund to borrow NAV Debt becomes intertwined with a desire to boost the returns of that sponsor's own private credit funds. It is even feasible that the same private equity sponsor could be acting as the NAV Debt lender and the buyout sponsor in the same fund.[300] Such a scenario is fairly unlikely since it would be a conflicted transaction

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[292] Fontenay, *supra* note 87, at 154-55; also *see* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1090 (2003).
[293] Magnuson, *supra* note 24, at 1900-02 (doubting the efficacy of reputational constraints based upon the inadequacy of information flow on private equity past behavior and performance, and the competing reputational concerns of a private equity firm between creditors and investors).
[294] Metrick and Yasuda, *supra* note 29, at 2328
[295] Morris & Phalippou, *supra* note 24, at 295.
[296] *Supra* note 48, and accompanying text.
[297] Robinson & Sensoy, *supra* note 257, at 2791.
[298] Fontenay, *supra* note 101, at 1113.
[299] McElhaney, *supra* note 20.
[300] Henderson & Birdthistle, *supra* note 31, at 57; Fontenay, *supra* note 101, at 1114 (by analogy, noting that private equity funds may invest in the debt and equity of the same portfolio company); Gara & Platt, *supra* note 207 (noting that, in 2023, Platinum Private Equity refinanced the acquisition debt for its portfolio company, Biscuit International, with $100 million of PIK debt provided by its own private credit fund).

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which typically requires LPAC consent under most limited partnership agreements.[301] If limited partners were to acquiesce to such an arrangement though, clearly significant conflicts could arise for investors in both the LBO and private credit funds, with determinations of valuations, enforcements and consent rights becoming blurred.[302]

Even outside of the obvious conflicts created by incestuous relationships, a desire to normalize NAV Debt in the industry may influence LBO fund decisions to incur NAV Debt. A sponsor may cause its buyout funds to utilize NAV Debt not because it is patently beneficial to its limited partners, but more to standardize the practice amongst LBO funds to enhance its private credit business.

A type of conflict that has proved to be less theoretical is where a private equity sponsor itself has a significant limited partner interest in the LBO fund. As discussed, it is not uncommon for firms to co-invest with limited partners to demonstrate skin-in-the-game,[303] and some firms will run a strategy where they derive a substantive portion of their returns not just from fees, but also from large direct investments in their own funds. If the firm has a very large direct interest in the fund, then the rationale for NAV Debt may be tied to the liquidity needs of the firm. For example, it has been reported that Softbank recently incurred $4 billion of liquidity NAV Debt on one of its own funds to distribute returns to itself as the largest investor in that fund and enable it to make new investments elsewhere.[304]

It is of no surprise therefore that limited partners have expressed concerns that fund financing, such as NAV Debt, can interfere with the alignment between limited partners and fund sponsors, with a Goldman Sachs survey finding that 42% raised misalignment as an issue, with only 8% considering such finance as alignment-enhancing.[305] However, as discussed next, disquiet regarding alignment does not only result from private benefit extraction motivations, but also from the disruption of the governance mechanisms that otherwise serve investors well.

C. *The Governance Challenges*

In Part III, the governance advantages of private equity were described. NAV Debt could, however, be implemented in a manner that compromises many of those very advantages that contribute to private equity-backed portfolio company performance.

For instance, one of the factors that makes leverage so attractive in an LBO context is the tax deductibility that can reduce a portfolio company's corporation tax burden.[306] That benefit is not secured with fund-level NAV Debt, since the borrowing entity will not form part of a taxable group with any of the portfolio companies and, therefore, NAV Debt interest will be more of a drag on returns than

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[301] Kastiel and Nili, *supra* note 98, at 39; Kay, *supra* note 50, at 54.
[302] Kastiel and Nili, *id*., at 40 (by analogy to continuation funds).
[303] *Supra* notes 102-103, and accompanying text.
[304] Louch et al., *supra* note 16.
[305] Witkowsky, *supra* note 10.
[306] *Supra* note 65, and accompanying text.

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regular acquisition debt. The distinction is most stark with offensive NAV Debt, since the debt is being used to acquire investments – a pursuit ordinarily undertaken with acquisition debt at the portfolio company-level. All other things being equal, to earn similar returns, the relevant investments will have to perform commensurately better than they would otherwise have had to if acquired using tax shield-preserving portfolio company-level acquisition debt.

A further potential governance loss with offensive NAV Debt is the disciplining effect of debt on managers of portfolio companies.[307] If the debt has been secured purely to acquire a new portfolio company or for completely refinancing acquisition debt, the relevant disciplining effect may still be present, albeit indirectly, since, in the absence of remaining portfolio company-level acquisition debt with covenants restricting distributions up the chain, it is more likely that the terms of the NAV Debt will require regular cash interest payments flowing from the relevant investment rather than PIK interest. However, if offensive NAV Debt has been incurred for multiple purposes or for bolt-on investments, covenants within the existing acquisition debt facility documents will, as discussed, necessitate NAV Debt PIK interest.[308] Managers of portfolio companies acquiring bolt-on investments will, assuming the bolt-on is profitable, enjoy greater cash-flow without a proportionate increase in regular interest payments. The total leverage (LTV) at the portfolio company-level decreases, which may change the mindset of managers or pull their feet a little further away from the performance-enhancing fire. Future empirical studies on the performance of investments during the current period of rising NAV Debt may be instructive.

Offensive NAV Debt with PIK interest could also have a subtle influence on the types of investments made by a fund. Private equity LBOs have been known to target mature companies with robust cash-flows to service regular interest payments on acquisition debt, rather than the early-stage growth companies favored by venture capital, where debt is not usually a factor in acquisition financing.[309] Completing investments, particularly bolt-on investments, with PIK interest NAV Debt opens-up the possibility of acquiring businesses that are not necessarily producing strong cash-flows. Portfolio company-level lenders would of course not entertain such lending, but a NAV Debt lender secured against the entire portfolio of companies (some of which will be more mature) at a low LTV will be more open to finance the acquisition. Of course, the interest must be paid back eventually, and the fund would be making the investment in the hope that its value will increase over time to eventually pay the PIK interest, rather than that interest being a drag on the returns of all the other investments in the portfolio. However, taking excessive risks on growth companies is not a strategy in which limited partners in private equity LBO funds envision the fund will follow. In the normal course, the leverage approach offsets that strategy, but with NAV Debt, that counterbalance may no longer be present.

[307] *Supra* notes 125-127, and accompanying text.
[308] *Supra* notes 197-199, and accompanying text.
[309] TALMOR & VASVARI, *supra* note 1, at 4.

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What's more, if the anticipated growth in cash-flow is not realized by the NAV Debt-financed investment, the contagion effect leads to other assets within the portfolio making up the shortfall.[310]

It has already been discussed how a pure American waterfall could motivate excessive risk-taking through the use of NAV Debt,[311] and that offensive NAV Debt for bolt-on investments could open-up a riskier strategy on the part of LBO funds than is ordinarily expected.[312] However, the incurrence of substantive NAV Debt could in other circumstances instead encourage overly cautious behavior by LBO funds. The beauty of the traditional LBO model with investments in insulated silos is that the fund can take risks with individual investments without compromising the returns from other investments. A private equity fund will not take quite the same "spray-and-pray" tactic as a venture capital fund, where one hugely successful investment can often outweigh numerous failures,[313] but the private equity fund can take risks with individual investments if opportunities present themselves safe in the knowledge that if the risk does not pay-off, other investments will not be impaired.[314] NAV Debt delicately changes the dynamic. As previously discussed, if a portfolio company were to become bankrupt (or even perform poorly short of bankruptcy), a portion of the NAV Debt may need to be paid-up as the LTV threshold is breached, possibly by selling healthy portfolio companies.[315] Accordingly, at an individual portfolio company-level, a fund may show greater caution when a poor decision no longer simply diminishes the prospects of that portfolio company but could also cause the fund to breach an NAV Debt financial covenant. The materiality of that shift in mindset will depend upon the amount of NAV Debt, the LTV threshold, and the reason for the incurrence of that debt. How that will impact private equity returns will be an interesting question for future research, but part of the outperformance of traditional private equity-backed portfolio companies over public companies could be ascribed to a greater dominance of "innovation over control" - private equity-backed companies do not have the pressures of a dispersed shareholder base and a public company corporate governance system that prioritizes risk management.[316] NAV Debt could bias that balance back toward control over innovation.

Another governance challenge or concern is the motivation to incur liquidity NAV Debt to free-up limited partner resources to invest in new funds that the private equity firm is establishing.[317] A conflict arises between the interests of the current fund and the interests of the private equity firm in

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[310] *See* Part IV(A) of this article.
[311] *See* Part IV(B) of this article.
[312] *See* text between *supra* notes 309 and 310.
[313] Bob Zider, *How Venture Capital Works*, HARV BUS REV 131 (November-December 1998); Brian J. Brughman, Elizabeth Pollman & Zenichi Shishido, *Recent Changes in VC Investments in the US and Their Implications*, JOINT CONFERENCE BY VENTURE LAW FORUM & ENTERPRISE LAW WORKSHOP (May 9, 2023) 1, 10, 16, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4670308
[314] In relation to the possibility that a private equity firm's desire to maintain its reputation within the credit markets could act as a constraint on taking too great a risk with any individual portfolio company, *see supra* notes 292-293, and accompanying text).
[315] *See* text accompanying *supra* notes 280-284.
[316] BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION, at 624 (1997); Brian R. Cheffins and Bobby V. Reddy, *Thirty Years and Done – Time to Abolish the UK Corporate Governance Code*, 22 J. CORP. L. STUD. 709, 724-5 (2022).
[317] *Supra* note 268, and accompanying text.

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ensuring the success of the next fund. This is a classic conflict often dealt with in limited partnership agreements by including a term that prohibits the firm from fund-raising for a new fund until the end of the investment period, or until a certain percentage of commitments has been drawn-down or invested.[318] Limited partners insist on such provisions to focus the investment manager's attentions on the current fund rather than stretching resources during the fund's vital investment phase.[319] Limited partnership agreements rarely, however, contemplate the indirect conflicts caused through the use of liquidity NAV Debt. Lumbering the fund with costly debt to safeguard the latest fund-raising may not be in the interests of the limited partners. To be sure, limited partners will appreciate distributions in some cases, but perhaps not if it is ultimately going to significantly impair returns. Additionally, limited partners are not a homogenous group – some limited partners may seek liquidity through NAV Debt whereas others see NAV Debt as a costly and unnecessary means of freeing-up cash resources, when, as discussed below, they may have other options to do so.[320] Indeed, as a senior investment executive of an LBO investor has said, "We don't want to pay a bank an eye-watering fee to get our cash back earlier".[321] The general partner will favor those investors who are more likely to invest in successor funds – usually the "core" or repeat investors, and may rationally jeopardize returns and the size of its carry in a predecessor fund by adopting liquidity NAV Debt if it supports the continued survival of its business through a successor fund.

Finally, the use of liquidity NAV Debt or offensive NAV Debt for refinancings to delay exits could moderate the pressure on a fund to improve portfolio company profits rapidly, which, as discussed, is a governance advantage of private equity.[322] Absent NAV debt, limited partner preferences for mid-life distributions or forthcoming acquisition debt maturity can drive exit schedules, motivating the fund to maximize portfolio company value before being forced to exit. However, with liquidity NAV Debt distributions can be generated disassociated from exits, and offensive NAV Debt enables refinancing of acquisition debt at maturity. If, from the outset, the general partner knows it has the "out" of NAV Debt, the pressure to create value quickly is loosened. A similar consideration applies to the use of continuation funds to delay exits. The mainstreaming of exit delay options could be another subtle tweak in private equity governance that may compromise the performance of the asset class as compared to previous vintages.

D. *Financial Manipulation*

Scrutinizing the impact of NAV Debt on the current and future returns of the fund, the private equity firm's compensation, and the fund's performance is complicated. Limited partners must be wary

[318] TALMOR & VASVARI, *supra* note 1, at 108.
[319] Fontenay, *supra* note 101, at 1115.
[320] *Infra* note 338, and accompanying text.
[321] Le & Lynn, *supra* note 239.
[322] *See* text accompanying *supra* notes 107-108.

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of a general partner's use of NAV Debt to potentially exaggerate certain performance metrics of the fund.

The ongoing performance of a general partner of a fund can be assessed under a variety of metrics. IRR is one obvious method of appraisal, and the most common when marketing new funds.[323] Additionally, "distributed to paid-in capital" (DPI), being all distributions made to limited partners expressed as a multiple of the capital paid into the fund, will give limited partners a measure of how quickly distributions are made after capital contributions ("cash-on-cash" value).[324] The total value of the fund to limited partners, "total value to paid-in capital" (TVPI) is the aggregate of DPI and "residual value to paid-up capital" (RVPI) which is the value of unrealized assets of the fund as a multiple of paid-in capital.[325]

Liquidity NAV Debt, and, when incurred to avoid drawing-down on limited partner commitments, offensive and defensive NAV Debt, can increase IRR, since the shorter the time over which limited partner paid-in contributions remain outstanding, the higher the figure,[326] and also DPI by either increasing distributions or moderating paid-in capital.[327] Although total fund performance assessed by TVPI cannot be manipulated by NAV Debt, since as DPI increases through the use of NAV Debt, RVPI declines as the net asset value of the fund declines as a result of the incurrence of debt, a cash-strapped limited partner may well have a laser-like focus on periodic distributions and, therefore, DPI. Accordingly, a general partner struggling through the exit logjam of recent years[328] may see real benefit in improving its performance benchmarks through NAV Debt without any corresponding improvement in the net asset values of investments, especially if it is currently also fund-raising for new funds and needs to embellish its credentials for marketing purposes in comparison to competitor funds with similar liquidity constraints.[329] Additionally, if the carry hurdle is based upon an IRR calculation, as is common,[330] improving that metric eases the receipt of the carry. All those improvements in performance metrics may be beneficial for the general partner, but it is at the expense of NAV Debt interest eating into ultimate returns, and the contagion risk of cross-collateralization.

Recallable liquidity NAV Debt creates further challenges for limited partners.[331] Even for limited partners who would otherwise welcome a mid-fund-lifecycle distribution, such distributions cannot be freely utilized since they will remain part of the limited partner's committed capital to the fund.[332] The conditions of recallability will have a bearing, but, more generally, recallable liquidity NAV Debt has

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[323] Fontenay, *supra* note 101, at 1121.
[324] Richard Lehman, *Distributed to Paid-In Capital (DPI)*, MOONFARE (December 5, 2023) https://www.moonfare.com/glossary/distributed-to-paid-in-capital-dpi.
[325] *Id.*
[326] *Supra* note 229, and accompanying text.
[327] Kerfoot & Joo, *supra* note 13.
[328] *See* text accompanying *supra* notes 241-252.
[329] Kerfoot & Joo, *supra* note 13.
[330] Fontenay, *supra* note 101, at 1121.
[331] *See* text accompanying *supra* notes 239-240.
[332] Le & Lynn, *supra* note 239.

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unsurprisingly been described as a "zero-sum game".[333] Given that such distributed cash cannot, while recallable, be used by the limited partner to invest in a new fund established by the private equity firm, the motivation of the general partner to make such a distribution is likely to manipulate the performance barometers of the fund.

Even without NAV Debt, studies have noted that limited partners should be cautious when assessing general partners on the basis of interim fund performance. On average, the performance of a successor fund bears very little correlation to the interim performance data for the predecessor fund provided by general partners at the time of the successor fund-raising.[334] There is more correlation between final total fund performance and successor fund performance, but, since successor fund-raising commonly occurs prior to the end of the predecessor fund, those final performance figures would not be known at the time of successor fund-raising.[335] NAV Debt is another tool with which general partners can exaggerate interim performance.

It would, however, appear that limited partners are becoming wise to the manipulation game, with reports that they are beginning to discount the credit given to general partners upon the use of liquidity NAV Debt when assessing their track records. Some, for instance, are measuring general partner performance on the basis of DPI "ex NAV loans".[336] The reasoning is that the use of NAV Debt is a cheat code which results in DPI not accurately reflecting the ability and skills of a general partner to create value. NAV Debt has "tilted returns too far towards financial engineering, rather than companies' underlying performance".[337] Furthermore, even though private equity firms often justify the use of liquidity NAV Debt as satisfying limited partner demands for periodic distributions and freeing-up of cash resources, for a large limited partner, such as a pension fund, that is seeking liquidity, it would be much cheaper for the limited partner to borrow against its own assets with a larger collateral base than the private equity fund in which it is partially invested.[338]

Although many limited partners may be looking past NAV Debt when evaluating the performance of LBO funds, the calculations and assessments can become intractable if the use of NAV Debt by a fund is prolific.[339] A fund may be incurring NAV Debt for multiple purposes at the same time – liquidity, offensive and defensive, and it may not be clear to limited partners how much NAV Debt is being used

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[333] *Id.* (noting that recallable liquidity NAV Debt reduces an investor's contributed capital to a fund, but increases its uncalled commitment).
[334] *See e.g.* Robert S. Harris et al., *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds*, 81 J. CORP. FIN. 1, 10, 14 (2023);
[335] *Id.*
[336] Witkowsky, *supra* note 10. Limited partners are also discounting returns from exits to continuation funds when scrutinizing the track record of general partners (*id.*).
[337] Antonie Gara & Will Louch, *Private Equity Groups Face Investor Scrutiny Over Tactics for Returning Capital*, FINANCIAL TIMES (October 11, 2023), https://www.ft.com/content/a8a7f384-00ac-4cdf-9a54-c8fbc6b9db3d
[338] Witkowsky, *supra* note 10. Josephine Cumbo, *Calpers to Invest More than $30bn in Private Markets*, FINANCIAL TIMES (March 19, 2024) https://www.ft.com/content/57eb4fa4-16d5-43aa-bdee-2ffec736b31d (reporting that recently the largest retirement fund in the U.S., Calpers, resolved to borrow against its assets to fund further investments).
[339] Gara & Louch, *supra* note 337 (noting that one consultant for investors was concerned that NAV Debt could make it more difficult for investors "to understand the percentage of the return that comes from fund finance versus the actual investment return"). ILPA, *supra* note 72 (by analogy noting the distortive effect of subscription facilities that makes "comparability of performance more challenging", with the use of fund-level debt increasing IRR but reducing TVPI).

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for each purpose. Many existing fund limited partnership agreements do not contemplate the use of NAV Debt at all,[340] with distribution waterfalls and carry determinations not taking it into account. Moreover, an intricate examination is required to determine whether a liquidity NAV Debt distribution relates to one or more investments where an American waterfall applies, with the consideration further complicated by the use of the NAV debt for multiple purposes. Startlingly, in some funds, general partners may be able to incur NAV Debt without even disclosing its use to limited partners.[341] That lack of transparency can impede limited partners from taking NAV Debt into account when assessing general partner performance, and whether carry payments are justifiable. Outside of the context of NAV Debt, the SEC has recently enacted rules that require registered private equity fund advisers to circulate quarterly statements to limited partners detailing fund fees, expenses and performance, as well as an annual financial statement audit of each fund it advises.[342] Relevantly, when formulating the rules, the SEC noted that a lack of transparency by private fund advisers can hinder even sophisticated investors from determining fund performance or identifying conflicts of interest.[343] At a time of enhanced regulator scrutiny, NAV Debt adds another layer of opaqueness to private fund operations.

Conflicts between investors are also high on the regulatory agenda, and, as discussed, the SEC recently passed rules pertaining to the use of side letters.[344] However, even without the formality of side letters, a private equity firm could prefer its "core", regular investors through the manipulation of IRR with NAV Debt. For example, if the remuneration of a fund manager of a core limited partner is based upon their individual annual (or quarterly) IRR performance across investments,[345] a general partner may indulge such a favored fund manager to maximize their personal remuneration by incurring NAV Debt to boost IRR even though it is not beneficial to the long-term performance of the fund in general.

VI. MAKING SENSE OF NAV DEBT AND PROTECTING LIMITED PARTNER INTERESTS

A. *Summarizing NAV Debt*

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[340] Le & Lynn, *supra* note 239. It is not surprising that limited partnership agreements entered into prior to the rise of NAV Debt as a mainstream instrument do not contemplate NAV Debt – Fontenay & Nili, *supra* note 109, at 925 (noting that limited partnership agreements are negotiated at the commencement of the fund, and represent "investors' only bite at the apple in setting the terms of their deal with the sponsor").

[341] Anecdotal interviews carried-out by this author with limited partners and fund lawyers suggests that where the limited partnership agreement is silent on the use of NAV Debt, some general partners are incurring NAV Debt without disclosure to limited partners (with its use only becoming evident from reverse engineering financial statements), while some general partners take the view that they should first obtain LPAC consent.

[342] 17 CFR 275.211(h)(1)-2 and 17 CFR 275.206(4)-10. Fund advisers must also provide a fairness or valuation opinion in connection with adviser-led secondary transactions (17 CFR 275.211(h)(2)-2).

[343] SEC, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews: Final Rule*, RELEASE NO. IA-6383 1, 16-18 (August 23, 2023).

[344] *Supra* notes 113-114, and accompanying text.

[345] *Supra* note 274, and accompanying text.

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The obfuscation and diversity of NAV Debt makes it a difficult tool to evaluate. Private equity firms and NAV Debt lenders can make good conceptual cases for its incurrence. Offensive NAV Debt provides a path to take advantage of opportunities to enhance fund returns that would otherwise be lost. Defensive NAV Debt allows a fund to ride-out periods of economic turbulence. Liquidity NAV Debt facilitates periodic distributions to limited partners without having to sell assets at a discount. However, the underlying logic for NAV Debt and its consequences may deviate from the ideological business case.

Starting with liquidity NAV Debt, judging by comments from limited partners, it does not appear that the demand by limited partners for early distributions through NAV Debt presumed by private equity firms and NAV Debt lenders is matched by reality.[346] Furthermore, the president of the Institutional Limited Partners Association (ILPA), an industry body for fund investors, was recently quoted, "Where there is the most consensus of LPs not liking the use of NAV-based facilities, it's for early distributions, especially when those distributions are recallable. That has very close to unanimous support as far as being against it."[347] Institutionally,[348] the incurrence of liquidity NAV Debt by a fund will rarely be financially beneficial for a large limited partner invested in that fund when it could simply incur the debt itself at a lower cost against its own assets if liquidity were urgent.[349] The clamour for liquidity by limited partners may not be as loud as the private equity industry suggests. The financial manipulation of fund performance measures, the potential to accelerate receipt of the carry, and maximizing management fee payments are more likely the real drivers of liquidity NAV Debt rather than an altruistic embrace of limited partner concerns. A desire of general partners to tactically provide limited partners with free-cash at the time of successor fund capital-raising will also weigh heavily on NAV Debt decisions – limited partners may not be so much cash-strapped, but may have maxed-out on their internal private equity LBO investment limits, hindering them from investing in successor LBO funds without returns of capital from predecessor LBO funds.

Liquidity NAV Debt clearly vexes limited partners. However, even more arguably benign forms, such as offensive NAV Debt, can cause consternation, with a senior director of ILPA exclaiming that the "vast majority" of limited partners do not support using NAV Debt generally.[350] Offensive NAV Debt changes the principles on which a fund make investments. The orthodox benefit from high leverage of a tax shield is lost, and the governance benefit from debt disciplining managers may be tempered. Certain uses of NAV Debt could also delay exits, alleviating the pressure (and incentive) on general partners to rapidly improve the efficiency of portfolio companies. The incentives surrounding

[346] *Supra* note 321, and accompanying text.
[347] Tom Auchterlonie, *ILPA's Prunier: "Vast Majority" of LPS Unsupportive of NAV Loans*, PRIVATE DEBT INVESTOR (April 2, 2024), available at https://www.privatedebtinvestor.com/ilpas-prunier-vast-majority-of-lps-unsupportive-of-nav-loans/
[348] Notwithstanding the use of NAV Debt being financially disadvantageous for limited partners as institutions, as discussed, an individual fund manager of a limited partner may see remuneration benefits from manipulation of IRR through the incurrence of NAV Debt by a fund in which that limited partner is invested (*supra* note 274, and accompanying text.).
[349] *Supra* note 338, and accompanying text.
[350] Auchterlonie, *supra* note 347.

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risk-taking in the traditional LBO model are also disrupted by NAV Debt, creating some incentives to take more risks, and others to take less. It is impossible to fully evaluate the governance changes introduced by offensive NAV Debt, as the machinations are complex and will vary on a case-by-case basis. However, for a limited partner, the dynamics of the investment change, and time will tell how that impacts private equity LBO returns.

As for defensive NAV Debt, this seems to be one of the more egregious disruptions to the traditional LBO model. Conventionally, if a fund holds a struggling asset and a greater return on equity can be realized by allowing the portfolio company to become bankrupt than continuing to service the acquisition debt, the rational choice is to put the company into bankruptcy.[351] Now, with the emergence of mainstream NAV Debt, the fund may instead incur defensive NAV Debt in the hope that a turnaround can be engineered. If the gamble is successful, that is obviously a positive for the fund, but it is a change to the LBO model. If the gamble is unsuccessful, unlike with the silo structure of the traditional LBO model, healthy assets may have to be sequestered to service the NAV Debt.

The cross-collateralization of assets across the fund could also have a pivotal influence on decision-making at a portfolio company-level. The traditional silo structure enables each portfolio company to be operated on an individual basis, often, in the case of large funds, with different teams within the firm taking responsibility for different investments. Decisions on growth, risk, refinancing, long-term investment, distributions and exits can each be made on a portfolio company-by-portfolio company basis, largely influenced by possible returns from those investments and the repayment of acquisition debt. With NAV Debt in the mix, teams overseeing each investment will also need to contemplate the repayment of the NAV Debt (and its accumulating interest in the case of PIK interest), as well as the performance of other investments across the portfolio when making decisions on their individual portfolio companies. When LTV is low and all the portfolio companies are performing well, NAV Debt may not have a meaningful effect on decision-making, but in times of stress, investment teams may come to different decisions on individual investments than would otherwise be made at a portfolio company-level in the absence of NAV Debt.

Ultimately, NAV Debt is a gambit by a private equity firm – betting the house on an improvement in economic conditions. NAV Debt is an attempt to maintain business as usual from the halcyon low-interest rate era, by embedding long-term liabilities that will eventually have to be discharged. The hope is that by the time the NAV Debt comes home to roost, the economy will have improved and exit values will be restored to previous record levels. It is a major bet on interest rates falling, and falling fast.[352] If exit values do not improve, general partners will have lumbered their funds with expensive debt that doubles-down on depressed returns.

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[351] Viktoria Dalko, *Leveraged Buyouts*, in THE HANDBOOK OF MERGERS AND ACQUISITIONS , at 308 (David Faulkner ed., 2012).

[352] Nick Timiraos, *Fed Cites Inflation Setback. Holds Rate Firm*, THE WALL STREET JOURNAL (May 2, 2024) https://www.wsj.com/public/resources/documents/FQPOaEtBW38ss8UNfIky-WSJNewsPaper-5-2-2024.pdf (suggesting that U.S. interest rates will remain higher for longer than originally envisioned by financial markets).

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B. *Limited Partnership Agreements Going Forward*

What should limited partners seek when negotiating limited partnership agreements? As aforementioned, often limited partnership agreements do not even contemplate the use of NAV Debt, being so alien to the regular LBO fund model. Pertinently, the ILPA has indicated that it will publish further guidance on NAV Debt given its recent prevalence and controversy in the market.[353] At least basic demands should be made on consent rights, transparency and disclosure.

Given the various conflicts that exist and the fact that the drivers of NAV Debt are not necessarily in the interests of the fund, limited partners would be wise to include that limited partner consent is required prior to the incurrence of NAV Debt.[354] For more benign types of NAV Debt, such as offensive NAV Debt, or where contagion risk is at its highest, such as with defensive NAV Debt, LPAC consent may be sufficient, since limited partner interests are generally aligned.[355] Where limited partner conflicts are more likely to arise, such as with liquidity NAV Debt, consent from a majority or even super-majority of the limited partners would be justified. For example, some limited partners may hanker for distributions through NAV Debt, while others are content to await exits. In such a case, it seems unfair that costly debt should be incurred right across the whole fund affecting all limited partners, when that subset of limited partners desperate for distributions could sell in the secondaries market[356] or procure limited partner financing themselves.[357] Indeed, it has been reported that, "Although many LPs…would rather wait for sales of portfolio companies for distributions and do not support the use of NAV loans, they usually don't get a say."[358] An LPAC consent could be biased by the LPAC's constituents being mainly those limited partners seeking early distributions to invest in successor funds, since the general partner may well have stacked the LPAC with its "core" investors.[359] Majority or super-majority limited partner consent would not entirely alleviate conflicts of interest between limited partners, but at least to the extent that a material number of limited partners object to liquidity NAV Debt, it could be averted. It appears that some limited partners have already begun asking for NAV Debt consent rights in new fund raises.[360]

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[353] Auchterlonie, *supra* note 347.
[354] Psychologically, a consent right for the fund to utilize NAV Debt would be more preferable to a veto right. With a veto right, the default scenario would be to allow the NAV Debt, creating a compunction on limited partners to proactively determine that the general partner is taking an action in the normal course but that the relevant action is against the interests of the fund; with a consent right, the limited partners are in a position where general partner is taking an action notionally outside the normal course of the fund, since the default is that NAV Debt not be utilized - Clayton, *supra* note 29, at 272 (noting that veto rights entail soliciting support from other investors).
[355] Even then, some limited partner fund managers may benefit from indirectly increased IRR from such NAV Debt (*supra* note 274, and accompanying text).
[356] *Supra* note 261, and accompanying text.
[357] *Supra* note 338, and accompanying text.
[358] Bucak, *supra* note 18.
[359] *Supra* note 99, and accompanying text.
[360] Gara & Louch, *supra* note 337.

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With respect to disclosure, studies have found that unless requirements are contractually recorded, limited partners receive very little fund information,[361] and private equity firms have incentives to conceal unfavorable information.[362] Therefore, provisions should also be included to ensure transparency when NAV Debt is contemplated, to fully-inform the exercise of NAV Debt consent rights, and to promote more accurate assessments of fund performance notwithstanding the potential muddying of the performance waters by NAV Debt. The general partner should be required to disclose comprehensively the terms of the NAV Debt, the reasons for its intended uses, and consequences from a fund performance and fees perspective. In the case of liquidity NAV Debt, any concurrent fund-raisings by the private equity firm should also be disclosed, and, in relation to offensive and defensive NAV Debt, clear information on the financial performance and prospects of any portfolio companies due to be funded should be outlined. For any NAV Debt, the same fund performance information provided to NAV Debt lenders should be provided to limited partners, including net asset valuations and acquisition debt maturities. The limited partnership agreement should also require the general partner to provide detailed information on how the NAV Debt could affect fund returns over the lifetime of the fund under varying economic (including interest-rate) assumptions.

The SEC may also have a role to play. Forthcoming rules will require LBO funds to disclose quarterly information on fees, expenses and fund performance (IRR and multiples of invested capital on a gross and net-of-fees basis).[363] Computations must be made "with and without the impact of any fund-level subscription facilities".[364] The SEC rationalized that simple "levered" performance figures can mislead an investor into believing that they represent the results that the investor has achieved from its investment in the fund.[365] Similar accusations could also be levied at NAV Debt. It would be prudent to extend the rules to require quarterly fund performance statements to disclose performance with and without the impact of *any* fund-level debt or debt for which the fund has repayment liabilities.

A thorny issue is fees. NAV Debt can distort the calculation, and accelerate the receipt, of fees. Distribution waterfalls should be drafted carefully, taking into account NAV Debt. For example, for an American waterfall, how liquidity NAV Debt distributions are allocated across individual investments needs to be considered, in order to determine whether it triggers the payment of the carry on any particular investment. More existentially, under both American and European waterfalls, it is incumbent upon limited partners to consider whether any carry credit should be given at all if it is triggered by the incurrence of NAV Debt – whether that be through distributions by way of liquidity NAV Debt, or the effect that all types of NAV Debt may have on IRR and DPI. The carry has not crystalized as a result of the skills and talents of the general partner or good performance of portfolio companies, but instead simply by financial engineering. It may be more efficient for the carry "generated" in such

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[361] Fontenay & Nili, *supra* note 109, at 978; Magnuson, *supra* note 24, at 1882-83; Clayton *supra* note 91, at 81.
[362] Magnuson, *id*., at 1862, 1882-3.
[363] 17 CFR 275.211(h)(1)-2.
[364] 17 CFR 275.211(h)(1)-2(e)(2)(ii).
[365] *Supra* note 343, at 128-9.

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circumstances to be parked until the end of the lifetime of the fund, rather than paying the carry early and relying on a clawback mechanism (if negotiated) later on. Additionally, NAV Debt should be factored into the management fee taper. If, after the investment period, the intention is that the management fee be calculated based upon remaining capital invested rather than capital commitments, a sensible approach would be to deduct any NAV Debt incurred (including accrued interest) from the remaining capital invested when calculating the management fee. Such an approach would moderate the incentive on a general partner to utilize NAV Debt simply to augment the management fee.

Finally, limited partners should also disassociate NAV Debt from the performance metrics that they use to assess the performance of general partners. NAV Debt can embellish the interim performance and returns of the fund, in a manner that is not necessarily representative of the actual overall performance of the fund and ability of the general partner – a crucial consideration when determining whether to support a successor fund.

C. *The Future of NAV Debt*

Reports on the growth of NAV Debt and hyperbole as to its future dominance would suggest that limited partners should be on guard, and, indeed, it would be prudent to consider NAV Debt carefully when negotiating limited partnership agreements. However, there are numerous factions within the private equity industry with a horse in the race which can lead to a degree of hubris when discussing NAV Debt, not least the lenders seeking returns, and general partners who can manipulate fund performance metrics, accelerate carry fees, and secure the success of new fund-raisings. Ingrained interests incentivize a desire to normalize NAV Debt as a practical private equity tool. Instead, the backlash from limited partners colors NAV Debt in a different light. Rather than an innovative financial instrument taking private equity by storm, it is really a technique to provide succour to a desperate industry during a tough period of high interest rates, few exits, and fund-raising challenges, which made fund investments at a time of low interest rates. The discounted cash-flow methodology used to value those acquisitions will have been based upon a lower cost of capital and an expectation that exits would take place prior to the maturity of the relevant debt. Acquisition prices will not have contemplated a refinancing of that debt at much higher interest rates, or for exit values to fall so precipitously.

NAV Debt is therefore more likely a child of its time. A tool to traverse a period when private equity funds have, in hindsight, heavily overpaid for investments. The next generation of funds will be valuing acquisitions based upon the prevailing economic conditions, with higher interest rates necessitating more circumspect pricing of acquisitions. Absent a further dramatic increase in interest rates or other severe economic shock over the lifetimes of those new funds, the use of NAV Debt is likely to subside. NAV Debt may remain a potent tool in the box of general partners during times of economic turbulence, but the backlash from limited partners to liquidity NAV Debt, and the contagion, governance and conflict concerns that arise from all types of NAV Debt will most probably lead to NAV

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Debt becoming rare in the normal course. Limited partners are also likely to demand greater consent rights on NAV Debt in new funds, making its incurrence less straightforward than in the prior vintage.

What of the current cohort of funds, which appear to have embraced NAV Debt with gusto? In essence, NAV Debt simply provides a short-term fix in the hope that improvements to the economy and exit values will offset the cost of the debt prior to the end of the fund. If the economy does not recover, the large LTV cushions adopted means that mass events of default and lenders enforcing security are unlikely.[366] However, the contagion-effect is real, and funds could be forced to divest of healthy investments to cure LTV threshold breaches. Even if the economy does recover, NAV Debt will still continue to accrue costly interest and the economy (and exit values) will have to improve sufficiently to outweigh the large interest burdens. Portfolio investments will have to knock the ball out of the park if funds that have incurred NAV Debt are to make returns comparable to previous fund vintages. From the general partner's perspective, if the NAV Debt interest rate exceeds the carry's hurdle rate, the performance of the fund will need to significantly outperform the hurdle if the general partner is to avoid a clawback of carry at the end of the fund. The jury's out on whether the gambit pays off for the current generation of funds. Longer dated funds may be fortunate, since they can wait out a longer period of time over which interest rates may fall, increasing exit values and additionally benefiting from the floating rate attached to most NAV Debt facilities.[367] Other funds, though, particularly those which have used liquidity NAV Debt toward the end of their lifetimes to free-up capital for limited partners, may well see significant hits to their TVPI come fund's end.

Cutting through the NAV Debt bluster, objectively, it is difficult to be convinced that NAV Debt will continue to rise exponentially as a finance technique, and it is, at best, a cyclical implement to solve specific market problems for certain participants. What can be sure, though, is that the next time economic circumstances lead to widespread attempts to adopt NAV Debt, limited partners will be far more savvy.

CONCLUSION

NAV Debt is a financial tool that has taken the private equity buyout industry by storm. Purveyors of NAV Debt extoll the benefits it can bring to funds, opening-up a new avenue to enhance limited partner returns. NAV Debt, however, comes with costs. The contagion effect caused by cross-collateralization of assets is an obvious detriment, but further more indirect costs are also evident, including an undermining of many of the governance advantages of the LBO model, the propensity to drive conflicted behavior by general partners, and the confusion it brings when attempting to evaluate fund performance. While lenders and sponsors have been quick to eulogize the merits of NAV Debt for

[366] Blumenthal, *supra* note 195.
[367] *Supra* note 200.

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limited partners, reports intimate that the clamor from limited partners for NAV Debt strategies is not as loud as those promoting the tool presume. A backlash of sorts has developed toward NAV Debt among the LBO investor community. The suggestion is that NAV Debt is creating greater costs than benefits for LBO funds.

What next for NAV Debt? Wild predictions abound that the industry is set for exponential growth, but it is largely self-interested participants making such claims, not least fund sponsors that run both buyout and lending fund strategies. The traditional LBO model, including the governance norms ingrained therein, has served private equity well, and the rise of NAV Debt is a zeitgeist reflective of a period during which an unexpectedly sharp rise in interest rates has scuppered the financial metrics on which legacy funds made investments. It is unlikely that NAV Debt will become a routine trait of the LBO model. A tool in the toolbox maybe, but not a fundamental piece of the engine. As for current funds that have incurred NAV Debt, it represents a risky gamble. For many, the accrual of large levels of interest payments will blight final returns. It may perhaps be overly melodramatic to suggest that investors should start listening for the gentle ticking of a time bomb ready to explode, but NAV Debt is certainly not the visionary, innovative evolution of the LBO industry proclaimed by some.

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