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

BOBBY V. REDDY*

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 fundraisings. Accordingly, the industry has sought to adapt, and net asset value loans ("NAV Debt") have 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 foundational principles of private equity. The article argues that although NAV Debt is versatile in its uses and conceptually can provide benefits for 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. This Article provides a comprehensive analysis of private equity governance, LBO risk compartmentalization, private benefits of control, and performance metrics in the midst of NAV Debt. 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 undermine investor rights and could pummel final returns. Although NAV Debt is perhaps not quite a ticking time bomb, it could represent a gamble that tarnishes a generation of funds.

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* Professor of Corporate Law and Governance, University of Cambridge; Global Distinguished Professor of Law, University of Notre Dame; J M Keynes Senior Fellow in Financial Economics; Former partner, Latham & Watkins LLP. I would like to thank the organizers of both The Law and Finance of Private Equity and Venture Capital Conference held at Penn Carey Law, University of Pennsylvania, and The Law and Economics of Organizations Conference held at the University of Lucerne, at which this paper was presented. I am grateful for the helpful comments from Anat Alon-Beck, Vince Buccola, William Clayton, Jesse Fried, Suren Gomtsian, Oleg Gredil, Assaf Hamdani, Chris Hale, Marc Moore, Elizabeth Pollman, Hiroyuki Watanabe and Simon Witney. I also thank all the incredibly helpful law firm partners, industry bodies, regulators, limited partners, and private equity practitioners who assisted with my research on this paper on a non-attributable basis. A blog of this paper was published in the Harvard Law School Forum on Corporate Governance (July 15, 2024).

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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. Toys "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 the acquisition, loaded on to the company's books.[2] Under the sheer weight of $400 million of interest per annum,[3] Toys "R" Us entered Chapter 11 bankruptcy in 2017, before succumbing to liquidation in 2018 and litigation that still haunts the former board today.[4] 30,000 U.S. jobs were lost, lenders took haircuts on their loans, and unsecured creditors such as suppliers and landlords lost a combined $800 million.[5] Furthermore, the private equity consortium lost $1.3 billion of investor contributions.[6] On its 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 other companies owned by the funds controlled by the private equity consortium were 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 capital to acquire Toys "R" Us, it was not forced to sell those companies to generate liquidity to satisfy the debts of Toys "R" Us. The traditional LBO model involves the establishment of a separate limited liability special purpose vehicle or vehicles ("SPVs") to acquire each individual portfolio company. Debt funding for each acquisition is incurred by an SPV acting as a holding entity solely for that specific acquisition, enabling 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

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[1] Eli Talmor & Florin Vasvari, International Private Equity ch. 13 (2011).

[2] *Id.*

[3] Nathan Vardi, *The Big Investment Firms That Lost $1.3 Billion in the Toys "R" Us Bankruptcy*, Forbes (Sept. 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/ [https://perma.cc/5AP8-SPJG].

[4] Ben Unglesbee, *The Story of Toys R Us' Bankruptcy is Still Unfolding, and it Still Matters*, Retail Dive (Jan. 20, 2022), https://www.retaildive.com/news/the-story-of-toys-r-us-bankruptcy-is-still-unfolding-and-it-still-matters/617429/ [https://perma.cc/2ZPU-TGP2].

[5] *Id.*; Ben Unglesbee, *How Toys R Us' Bankruptcy Hopes Came Crashing Down*, Retail Dive (Mar. 15, 2018), https://www.retaildive.com/news/how-toys-r-us-bankruptcy-hopes-came-crashing-down/519230 [https://perma.cc/KVH7-KS29].

[6] Vardi, *supra* note 3.

Toys "R" Us, overall, investors in the fund earned large positive returns,[7] 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, and the fund itself generally does not incur liabilities. However, circumstances have changed—the LBO model still lives on, but in many cases, not as we know it.

In the face of a hostile economy resulting from the double blow of a high-interest-rate environment and global economic uncertainty, private equity has sought to adapt, stress-testing the limits of the customary 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 Debt"). However, the rise of NAV Debt does not so much merely push the boundaries of the asset class but rather takes a sledgehammer to the finely curated standard rules of private equity. NAV Debt essentially involves long-term debt financing at the fund level. The debt is borrowed against the net asset value of *all* the investments of the fund. Noting that the underlying assets are heavily leveraged themselves, NAV Debt has recently been excoriated as being "leverage-on-leverage,"[8] and, crucially, NAV Debt represents a liability at the fund level with the debt not 'siloed' in an SPV holding a specific portfolio company.

Although NAV Debt has been around for years,[9] historically, it was the preserve of credit, secondaries, and infrastructure funds.[10] In particular, NAV Debt was common in the fund-of-funds sphere, where a fund would borrow against the value of its interests in other funds.[11] It was rare for LBO funds to borrow against the value of all the portfolio companies owned by the fund. To the extent that LBO funds did incur NAV Debt, it was usually new players

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[7] 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. Or. Pub. Emps. Ret. Fund, Private Equity Portfolio 4 (Mar. 31, 2023); Wash. State Inv. Bd., Private Equity Portfolio Overview by Strategy 2-2 (Dec. 31, 2022); Minn. State Bd. of Inv., Comprehensive Performance Report 80 (Mar. 31, 2024).

[8] Valerie Martinez, *Bank of England Official Raises Alarm Over Private Equity Use of NAV Loans as Exits Slow*, Inv. Week (Apr. 22, 2024), https://www.investmentweek.co.uk/news/4199872/bank-england-official-raises-alarm-private-equity-nav-loans-exits-slow [https://perma.cc/25Y6-897B] (reporting a speech by a Bank of England official).

[9] Chris Witkowsky, *Continuation Funds, NAV Loans Potentially Disruptive of LP/GP Relationship: Goldman Survey*, Buyouts (Sept. 27, 2023), 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 [https://perma.cc/UBQ4-UUN8].

[10] Darlen G. Leung & Amanda C. Balasubramanian, *NAV Fund Financing on the Rise for Private Equity*, Torys Quarterly (Summer 2022), https://www.torys.com/en/our-latest-thinking/publications/2022/07/nav-fund-financing-on-the-rise-for-private-equity [https://perma.cc/6KZY-K8R3].

[11] Meyer C. Dworkin & Samantha Hait, *The Continuing Evolution of NAV Facilities*, in GLI – Fund Finance 2019 (Michael C. Mascia ed., 3rd ed. 2019).

in the market or smaller private equity sponsors acquiring distressed assets that did not have the reputation or scale to convince lenders to provide risky loans purely against the assets of individual investments.[12] The onset of the pandemic saw NAV Debt hit the big time. 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.[13] The more recent economic shock of high interest rates which has hammered the LBO industry, causing leverage for acquisitions to become more costly, exit valuations to plummet, and a lack of investor liquidity to support new fund raises, has further drawn NAV Debt back into the mainstream.[14] In recent years, funds sponsored by LBO behemoths The Carlyle Group, 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.[15]

According to the Fund Finance Association, the 2023 global market for NAV Debt was approximately $100 billion,[16] with reports that the market had doubled within the previous two years.[17] Purveyors of NAV Debt have been buoyant, with one lender predicting year-on-year growth of 30–50%,[18] with the market tripling by the end of 2025,[19] and reaching $600 or $700 billion by 2030.[20] As demand has expanded, so has supply, with a secondaries advisor noting that 30 new NAV Debt lenders had entered the market in the first

[12] Matthew K. Kerfoot & Jinyoung Joo, *Key Drivers Behind Widespread Adoption of NAV Financing*, Proskauer Law360 (Aug. 24, 2023), https://www.proskauer.com/pub/key-drivers-behind-widespread-adoption-of-nav-financing [https://perma.cc/6M9R-C2EX].

[13] Leon Stephenson & Bronwen Jones, *NAV Finance: Now and the Future*, Priv. Equity Int'l (May 22, 2023), https://www.privateequityinternational.com/nav-finance-now-and-the-future/ [https://perma.cc/8Q6A-7U74].

[14] Kerfoot & Joo, *supra* note 12 (noting the rise of megacap sponsors seeking NAV Debt facilities in excess of $1 billion).

[15] Will Louch et al., *Buyout Groups Raise Debt Against Portfolios to Return Cash as Dealmaking Slows*, Fin. Times (July 18, 2023), https://www.ft.com/content/f23d9cd9-2650-4943-a9ac-eb262414e772 [https://perma.cc/BD7V-MRMS].

[16] Sean Lightbrown, *The Rise of NAV Lending in Private Equity*, Moonfare Insights (July 6, 2023), https://www.moonfare.com/blog/what-is-nav-lending [https://perma.cc/5BYL-H2LM]; Selin Bucak, *Investors Question PE Funds' Use of NAV Loans and Capital Calls*, Citywire (Nov. 7, 2023), https://citywire.com/pro-buyer/news/investors-question-pe-funds-use-of-nav-loans-and-capital-calls/a2429893 [https://perma.cc/DY7X-T48A].

[17] Stephenson & Jones, *supra* note 13.

[18] Alicia McElhaney, *Private Equity's Woes Spur Rise in NAV Loans – and Managers Offering Them*, Institutional Inv. (Aug. 18, 2023), https://www.institutionalinvestor.com/article/2c2p0gk8pjstkz630fdvk/corner-office/private-equitys-woes-spur-rise-in-nav-loans-and-managers-offering-them [https://perma.cc/4Z7U-L95M].

[19] *Huge and Growing: The Rise of NAV Financing*, Financier Worldwide (Aug. 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 [https://perma.cc/E3KC-YXBC].

[20] *Id.*; Lightbrown, *supra* note 16; Bucak, *supra* note 16.

quarter of 2023 alone.[21] 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 research article of any discipline to scrutinize the rising tide of NAV Debt incurrence by private equity LBO funds.[22] NAV Debt is arguably the hottest topic in private equity, with its controversial nature provoking the Securities and Exchange Commission (SEC) to investigate the phenomenon.[23] This Article opens the academic discourse by being the first to examine in depth the consequences of NAV Debt on LBO fund governance, performance, and dynamics. The key contribution this paper makes is to outline in detail, for the first time, the conceptual and practical benefits and costs of NAV Debt, providing an invaluable and unique resource for policymakers, private equity investors, and students in the field of private equity. In particular, this Article makes a novel contribution to the existing literature on private equity. Much of the existing academic discourse on private equity LBOs focuses on the benefits of the private equity model over the publicly traded company. This Article explains how NAV Debt disrupts that model and how the introduction of NAV Debt challenges the assumptions on which private equity is usually scrutinized.

This Article categorizes NAV Debt 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 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.

In terms of benefits, NAV Debt is arguably 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

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[21] Amy Carroll, *The Rise of NAV Lending*, Buyouts (June 1, 2023), https://www.buyoutsinsider.com/the-rise-of-nav-lending/ [https://perma.cc/V6MZ-7N26].

[22] Note, however, a recent short essay on NAV Debt released after this paper was published on SSRN. *See generally*, Colleen M. Baker, *Net Asset Value Financing and Private Equity*, 171 U. PA L. Rev. Online 45 (2024).

[23] Bill Myers, *SEC Scrutinizing NAV Loans and Sub Lines, Top Examiner Says*, Priv. Funds. CFO (May 23, 2024), https://www.privatefundscfo.com/sec-scrutinizing-nav-loans-and-sub-lines-top-examiner-says/ [https://perma.cc/63R7-JMGJ].

when interest rates decline. 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 investments at bottom-of-the-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 fundraising for successor funds established by the same private equity sponsor.

However, conceptual benefits give way to real-world risks. This Article presents four categories of threats that 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 describes 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 can subtly change the mindset of decision-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] but many of those governance advantages may be weakened by NAV Debt. For example, this Article discusses how NAV Debt interest payments cannot be deducted from portfolio company profits for

[24] SIMON WITNEY, CORPORATE GOVERNANCE AND RESPONSIBLE INVESTMENT IN PRIVATE EQUITY 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 AM. ECON. REV., 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. AFFS. (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.

corporation tax purposes, the use of NAV Debt could lengthen holding periods of portfolio companies, NAV Debt could result in debt generally providing less of a disciplining effect on portfolio company managers, and NAV Debt could enable an 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. 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 and the 'rules' of private equity are 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, characterized 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 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. Part VI discusses recommendations for investment terms that investors in LBO funds should consider and concludes with predictions for the future of NAV Debt.

This Article ends by arguing that NAV Debt can drive a coach-and-horses through the finely tuned series of incentives and governance structures which have underpinned private equity during the boom times. Although a case can be made for the merits of NAV Debt in certain circumstances, even its most benign forms change the dynamics of the LBO model on which investors have based their investments; and at worst, NAV Debt is simply a risky gamble on economic improvement that could hammer the returns from a generation of LBO funds. While not quite a ticking time bomb, NAV Debt may, in years to come, be looked back on as a short-lived and ill-conceived response to longer-term economic headwinds.

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).

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 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."[26] Fundamental to that definition is the collation of equity finance from private investors into a "fund."[27] Such a fund is established and managed by the private equity firm, and it is the fund which then invests in portfolio companies.

The most common vehicle used for U.S. private equity funds is the limited partnership, with investors investing as limited partners in the fund.[28] The limited partnership neatly fulfills the tenets of investors—the liability of limited partners is limited to the contributions they make, or have committed to make, to the partnership,[29] 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.[30]

A limited partnership must have a general partner, which has unlimited liability for the debts and liabilities of the fund.[31] 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

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[25] Winston Churchill, Speech to the Royal Academy, Burlington House, London (Apr. 30, 1953).

[26] The definition has been coined by the author of this Article.

[27] Timothy Spangler, The Law Of Private Investment Funds ¶ 1.02 (3d ed. 2018).

[28] Tim Jenkinson, Hyiek Kim & Michael S. Weisbach, *Buyouts: A Primer*, NBER Working Paper Series No. 29502 1, 8 (2021); 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. & Bus. Rev. 249, 259 (2017).

[29] For example, in Delaware, *see* Del. Code tit. 6, § 17-303(a) (2024).

[30] Todd Henderson & William A. Birdthistle, *One Hat Too Many? Investment Desegregation in Private Equity*, 76 U. Chi. L. Rev. 45, 50 (2009).

[31] Jenkinson et al., *supra* note 28, at 9.

from management. If a limited partner becomes too closely entangled with management of the fund, it could lose the benefit of limited liability.[32] The limited partners contractually agree, within strictly defined limits, to make capital contributions to the fund ("commitments") when called upon by the general partner.[33] 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.[34] The private equity professionals who carry out the real work of managing the fund are housed within an investment manager entity to which investment management duties are delegated by the general partner.[35]

Private equity funds have finite lifetimes and are sometimes described as "closed-end" funds.[36] The traditional private equity fund has a ten-year lifecycle, although most funds also permit the general partner to extend the lifetime of the fund by two to three years (and even further with limited partner consent).[37] 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 ("capital calls").[38] Subsequent to, and also overlapping with, the investment phase is the "exit or harvesting phase," during which time the fund can divest of investments. After the investment phase, the fund must prioritize the sale of portfolio companies ("exits") and cannot call for 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 with assets distributed to limited partners.[39]

B. Private Equity Compensation

In what is a standard theme with private equity, the fee arrangements for the industry can be byzantine. A variety of fee structures exist with significant diversity in payment mechanics. However, one model is the infamous

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[32] 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 (Del. Code tit. 6, § 17-303(a) (2024)).

[33] Josh Lerner et al., Venture Capital & Private Equity: A Casebook 67 (5th ed. 2012), (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).

[34] Jenkinson et al., *supra* note 28, at 11.

[35] *Id.* at 10.

[36] Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. Econ. Persp. 121, 123 (2009).

[37] *Id.* at 123; Jenkinson et al, *supra* note 28, at 13.

[38] Blaze Cass et al., *Private Markets Fees Primer*, Meketa Inv. Grp. White Paper (Oct. 2019), https://meketa.com/wp-content/uploads/2012/10/Private-Markets-Fees-Primer-FINAL.pdf [https://perma.cc/SDP3-VLS9].

[39] Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, 33 Del. J. Corp. L. 1, 11 (2008).

'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[40]), and performance-related compensation, known as the "carry" or "carried interest," equal to 20% of profits.[41] Although the numbers can vary between funds, 2-and-20 has proved remarkably sticky.[42] U.S. federal and state tax regimes make it tax beneficial to the private equity firm for the management fee to be paid to the investment manager and the carry to the general partner.[43]

Some buyout funds will taper the management fee, ramping it down over the lifetime of the fund.[44] During the investment phase, the private equity firm must undertake the heavy lifting, identifying possible target companies, undertaking due diligence, 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 simply reduced after the investment phase, or, more commonly, the basis of its calculation changes from a percentage of contributed *and* committed capital to a percentage of remaining invested capital.[45]

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".[46] Historically, the hurdle has oscillated around the 8% level.[47] 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.[48]

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

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[40] Metrick & Yasuda, *supra* note 28, at 2310.

[41] *Id*. at 2310–11.

[42] Jenkinson et al., *supra* note 28, at 17.

[43] DEBEVOISE & PLIMPTON, PRIVATE EQUITY FUNDS: KEY BUSINESS, LEGAL AND TAX ISSUES 1, 37, 45 (2020); Nicole Kalajian, *Private Fund Structuring "101"*, VALUEWALK (June 9, 2020), https://www.valuewalk.com/private-fund-structuring-101/ [https://perma.cc/B7B9-FYPM].

[44] TALMOR & VASVARI, *supra* note 1, at 32.

[45] *Id.*; Cass et al., *supra* note 38 (the management fee may alternatively shift to a percentage of the net asset value of the portfolio after the investment phase).

[46] Metrick & Yasuda, *supra* note 28, at 2312; Jenkinson et al., *supra* note 28, at 20.

[47] *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 51 (Chris Hale ed., 2020) (noting lower hurdle rates during low interest rate periods).

[48] Metrick & Yasuda, *supra* note 28, at 2312.

the hurdle rate on their entire investment in the fund.[49] Therefore, even if the fund sells one of its portfolio companies at a large profit,[50] 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.[51]

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.[52] 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.[53] 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.

In the context of buyout funds, the American waterfall presents disadvantages for limited partners. An investor in an overall poorly performing fund could see the general partner receive a performance-related bonus even if only one fund portfolio company investment out of ten proved to be successful. No doubt it will stick in the throat of an investor if the general partner receives 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 the U.S. as well as Europe.[54] 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 portfolio companies have been divested toward the end of the lifetime of the fund.[55] For the majority of the fund's life, the general partner may be required to maintain its costs solely through the management fee, which, as discussed above, may ramp down over the life of the fund. This can create difficulties for small private equity funds, especially those with only limited funds established and without significant resources.

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[49] First National Realty Partners, *What is The Difference Between the American and European Equity Waterfall Structures?*, FNRP Blog (Mar. 2, 2022), https://fnrpusa.com/blog/american-vs-european-equity-waterfalls/#:~:text=In%20a%20European%20waterfall%2C%20the,time%20as%20the%20Limited%20Partners [https://perma.cc/L7QF-RWNF].

[50] Typically, private equity funds acquire five to fifteen portfolio companies. Morris & Phalippou, *supra* note 24, at 296. The average is ten portfolio companies over the life of the fund. Jenkinson et al., *supra* note 28, at 66.

[51] *Differences Between American and European Equity Waterfalls*, Eqvista, https://eqvista.com/equity/differences-american-european-equity-waterfalls/ [https://perma.cc/3SUQ-CKSG] [hereinafter Eqvista].

[52] First National, *supra* note 49.

[53] Eqvista, *supra* note 51.

[54] Ji-Woong Chung & Hong Jeong, *Waterfall in Private Equity*, *in* The Palgrave Encyclopedia of Private Equity (Douglas Cumming & Benjamin Hammer eds., 2023). Debevoise, *supra* note 43, at 39 (noting that a private equity firm establishing its first fund, or without an extensive track record, will unlikely be able to insist upon a pure American waterfall).

[55] Eqvista, *supra* note 51.

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.[56] 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. This requires general partners to pay back a portion of the carry (usually net of tax paid on any portion of the carry earned) if they received more than appropriate based upon a continuing whole fund determination of limited partner returns.

C. The Use of Debt

It is all in the name. The moniker "*leveraged*" buyout reflects the use of high levels of debt to complete portfolio company acquisitions.[57] Traditionally, private equity buyouts have employed 60-90% debt with the remainder provided by equity contributions from limited partners.[58] Although the current high interest rate 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[59]—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 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 deducted from the pre-tax profits of the relevant portfolio company for the purposes of corporate tax.[60] Such a "tax shield" reduces the taxable income of the portfolio company, in turn reducing its tax burden. Second, debt leverages positive returns.[61] To take a simplified example—if a portfolio company is acquired by a fund for $500 million,

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[56] *Id.*

[57] Jenkinson et al., *supra* note 28, at 8.

[58] Kaplan & Strömberg, *supra* note 36, 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%).

[59] Nussbaum et al., *Private Equity in 2023—A Year (Not) to Remember* 1, 3, WACHTELL, LIPTON, ROSEN & KATZ (January 10, 2024), https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28472.24.pdf [https://perma.cc/6PZR-WV8M]

[60] *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 28, at 39; Kaplan & Strömberg, *supra* note 36, at 131, 134.

[61] 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://perma.cc/FJ6R-BAKW].

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 similarly 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 compared with a pure equity-funded acquisition.

Debt is the (not so) secret sauce of private equity, once described as the "rocket fuel" of the industry.[62] 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 of those portfolio companies in terms of firm value matched the public markets (even if 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 is 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.[63] 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 the 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 the transfer of those sums, so that contributions can be

[62] Henry Sender, *How Could Buyers Resist Taking Those Terms*, The Wall Street Journal (Aug. 25, 2007), https://www.wsj.com/articles/SB118799505991608357 [https://perma.cc/VWZ4-GD8S] (quoting Bill Conway, co-founder of The Carlyle Group).

[63] Jenkinson et al., *supra* note 28, at 26.

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.[64] Since limited partners likely have a non-trivial notice period within which to provide capital,[65] 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.[66] 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.[67] For larger private equity funds with sophisticated, well-resourced limited partners, such debt is viewed as low-risk for the fund and lenders[68]—the debt merely solves a timing issue.

It is not uncommon for limited partnership agreements to prohibit or restrict the fund itself from incurring debt other than short-term subscription facilities.[69] 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.[70] Generally, the fund will have no obligations to third parties, and therefore will not suffer liabilities.[71]

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

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[64] *Id.* at 1, 14; Leung & Balasubramanian, *supra* note 10.

[65] The standard drawdown notice period is 10 to 15 business days. Thomas Draper, Patricia Lynch & 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).

[66] Jenkinson, *supra* note 28, at 14; Leung & Balasubramanian, *supra* note 10.

[67] Jenkinson, *supra* note 28, 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).

[68] Jenkinson, *supra* note 28, at 14.

[69] Patricia C. Lynch & Patricia Texeira, *NAV Financing: A Terrific Tool for Savvy Fund Sponsors*, ROPES & GRAY INSIGHTS (Oct. 11, 2022); Kaplan & Strömberg, *supra* note 36, at 123.

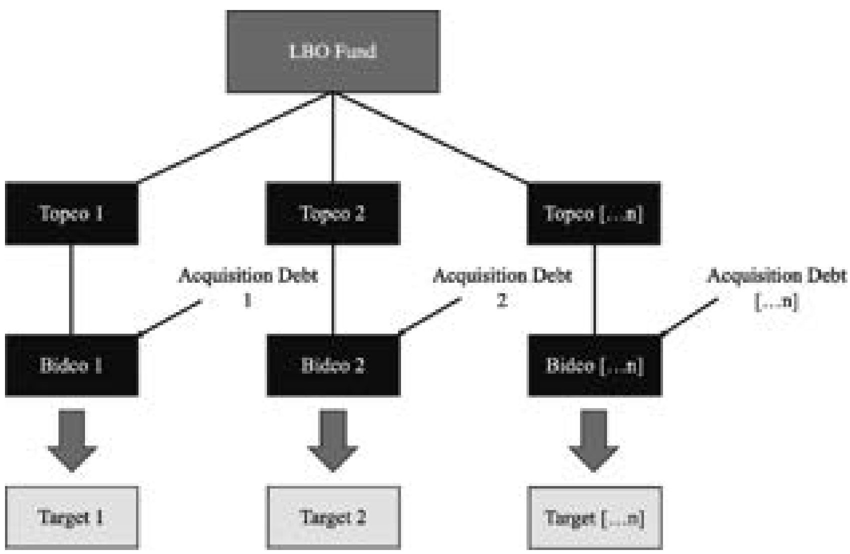
[70] William Curbow, Kathyrn Sudol & Atif Azher, *Getting the Deal Through: United States*, *in* PRIVATE EQUITY 2011 (2011), at 310–11 (Casey Cogut ed., 2011).

[71] A possible exception to the "rule" is the equity commitment letter that sellers of a portfolio company may request from the fund, to assuage concerns that the counterparty to the purchase agreement is merely a shell [annotated in Figure 1 as bidco]. The letter puts the fund under an obligation to equity finance the relevant topco and bidco entities acquiring the portfolio company with the non-debt portion of the purchase price. *Id.* at 310–12. However, often the letter can be enforced only by topco and bidco which will, except in the case of bankruptcy, be under the control of the fund.

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.[72] The fund subscribes to shares in a "topco" vehicle with the capital contributions made by limited partners.[73] Topco itself subscribes for shares in a "bidco" vehicle using the subscription proceeds it has received from the fund.[74] 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.[75] Upon closing, bidco will pay the purchase price for the target to the sellers from the financing provided by both the debt and limited partner contributions (through topco), with the target becoming a subsidiary of bidco or through bidco merging into the target company.

FIGURE 1: SIMPLIFIED PRIVATE EQUITY LBO ACQUISITION STRUCTURE



[72] 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.

[73] *Id.*

[74] *Id.*

[75] *Id.* If the debt is split into senior debt and junior debt underwritten by different finance providers, a further "midco" vehicle which borrows the junior debt is often inserted between topco and bidco to structurally subordinate the junior debt to the senior debt. Kaplan & Strömberg, *supra* note 36, at 124–25.

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 of its assets.[76] 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 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, the debt is essentially pushed down to the portfolio company.[77] 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 on that loan, but it is also precluded from enforcing against the assets of any other portfolio company owned by the fund.[78] The portfolio companies are effectively isolated from each other, with individual borrowers and lenders for each acquisition. If there is a default under one debt facility, the lender can only enforce against the assets of the portfolio company that the debt was used to acquire, and the fund will not have to sell other portfolio companies to satisfy the defaulted debt. 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.

Adherence to such "rules" elegantly protects the fund from liabilities and insulates investments in siloes. These 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

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

[77] 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 28, at 11.

[78] Elisabeth De Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANK. & FIN. L. 115, 122 (2013-2014).

corporations and the managers of those corporations.[79] The economic theory is that where an economic (rather than a 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.[80]

The private equity paradigm is not immune to agency costs. Agency costs can arise at the fund and portfolio company levels. This Part identifies the conflicts of interest and governance challenges that can create agency costs, 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 this Article 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 the principals' 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.[81]

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;[82] (ii) economically, by aligning the interests of the private equity firm with the limited partners;[83] and (iii) contractually, through protections in the limited partnership agreement.[84]

In relation to monitoring, limited partners will generally 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 could deter such individual monitoring. The free-rider deterrence that afflicts monitoring of management by shareholders in dispersed ownership publicly traded corporations[85] is also apparent, to a lesser degree, in private equity funds.[86]

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[79] *See e.g.* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[80] Jensen & Meckling, *id.*, at 308, 312–30.

[81] William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. REG. 67, 75 (2020).

[82] WITNEY, *supra* note 24, 187–93.

[83] TALMOR & VASVARI, *supra* note 1, at 33.

[84] Clayton *supra* note 81, at 75.

[85] 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).

[86] Clayton, *supra* note 28, at 272.

On an individual basis, a single limited partner may be hesitant to expend the costs and resources to monitor the private equity 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.[87] A common solution is to constitute a limited partner advisory committee (LPAC) in the partnership's constitutional documents, composed of a sub-set of limited partners.[88] Usually, the largest investors in the fund (or those with longstanding relationships with the private equity firm) will serve on the LPAC.[89] The LPAC neatly deals with free-rider issues, 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.[90] 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 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.[91] 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, limited partners will often further require the firm to co-invest with the limited partners—ensuring that the private equity firm has "skin in the game."[92] 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.[93]

Limited partners also protect their rights and potentially reduce agency costs contractually by negotiating terms into the limited partnership agreement.[94] At a rudimentary level, the limited partnership agreement will specify

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[87] *Supra* note 32 and accompanying text.

[88] Kobi Kastiel & Yaron Nili, *The Rise of Private Equity Continuation Funds*, 172 U. PENN. L. REV. 1601, 1609 (2023)

[89] *Id*. at 1644.

[90] TALMOR & VASVARI, *supra* note 1, at 26, 107.

[91] LERNER ET AL., *supra* note 33, at 71; Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B. U. L. REV. 1095, 1105 (2019).

[92] Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259, 287 (2010); Kaplan & Strömberg, *supra* note 36, at 123 (noting that it is customary for the general partner to contribute at least 1% of the total capital).

[93] Kay, *supra* note 47, at 52.

[94] Jenkinson et al, *supra* note 28, at 13.

the capital commitments of each limited partner, when they can be called and on what notice, allocations of limited partners, restrictions on when the firm can establish future funds, and duties, responsibilities, and liabilities of the general partner and investment manager.[95] Importantly, the limited partnership agreement will also put the private equity firm under an onus to obtain the acquiescence of the limited partners (or LPAC) before the fund can take certain actions.[96] 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,[97] the private equity firm is on the clock from the day the fund is established. Not only is there an incentive for the private equity firm to work assiduously to identify, conduct due diligence on, and acquire suitable targets, but, also, having acquired those portfolio companies, there is an impetus to make those companies more efficient and 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.[98] That time pressure is likely one of the factors buttressing the success of private equity-backed companies.

B. Agency Costs at the Portfolio Company Level

Extending the economic agency costs concept, at the portfolio company level, the fund is the principal, and the managers of the portfolio company are the 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.[99] The fund will likely not be as diversified as an institutional shareholder in a publicly traded firm,[100] will have a significant majority interest in the portfolio company, and will have an interest which is

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[95] Talmor & Vasvari, *supra* note 1, at 105–09.

[96] *Id.*

[97] *See* text accompanying *supra* notes 37–39. Jenkinson et al, *supra* note 28, at 13 (noting that the average life of an LBO fund is around 13 years).

[98] Cheffins & Armour, *supra* note 39, at 14.

[99] Fontenay, *supra* note 78, at 119; Masulis & Thomas, *supra* note 61, at 228; Magnuson, *supra* note 24, at 1860.

[100] *See supra* note 50.

largely illiquid.[101] 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 enabled through directors nominated by the fund to the board of the relevant portfolio company.[102]

Along with the pressure on private equity funds to turn a profit on investments within a short period of time,[103] 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.[104] 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.[105] 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.[106] 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.[107]

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,[108] saddling them with far more debt than the typical publicly traded company. Several studies have commented upon the propensity for debt to have a disciplining effect on managers.[109] Due to 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.[110] 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

[101] LERNER, *supra* note 33, at 6.
[102] Masulis & Thomas, *supra* note 61, at 228.
[103] *See* text accompanying *supra* notes 97, 98.
[104] Luc Renneboog & Tomas Simons, *Public-to-Private Transactions: LBOs, MBOs, MBIs and IBOs* 8–9 (TILEC Discussion Paper, No. 2005-023, 2005).
[105] Masulis & Thomas, *supra* note 61, at 252; Kaplan & Strömberg, *supra* note 36, at 130.
[106] Fontenay, *supra* note 91, at 1104; Morris & Phalippou, *supra* note 24, at 295.
[107] Kaplan & Strömberg, *supra* note 36, at 131.
[108] *Supra* notes 76, 77 and accompanying text.
[109] *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 36, at 131.
[110] *Id.*

of management, requiring them to adhere to strict budgets.[111] High leverage has been identified as a significant advantage in the private equity LBO model over the stereotypical publicly traded company.[112]

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.[113] 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.[114]

The reliable facets of the private equity LBO model from fund structuring and private equity compensation through 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 now entered the fray, tearing up the rules. In this Part, the nature and operation of NAV Debt is outlined, as it has seemingly become a mainstay of the brave new high-interest rate world of private equity.

A. The Nature and Structure of NAV Debt

NAV Debt is debt borrowed against the value of that fund's entire investment portfolio, net of any asset level debt.[115] 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.[116] A lender will determine whether to make the loan based upon

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[111] Krishna G. Palepu, *Consequences of Leveraged* Buyouts, 27 J. Fin. Econ. 247, 251 (1990); Cheffins & Armour, *supra* note 39, at 13.

[112] Jensen, *Eclipse*, *supra* note 109.

[113] Witney, *supra* note 24, at 48.

[114] Darryl J. Cooke, Private Equity: Law and Practice, 196–98 (7th ed., 2021).

[115] Kiel A. Bowen et al., *The Advantages of Net Asset Value Credit Facilities*, Mayer Brown Insights (March 29, 2023) https://www.mayerbrown.com/en/insights/publications/2023/03/the-advantages-of-net-asset-value-credit-facilities [https://perma.cc/8KE5-AXD3]; Lightbrown, *supra* note 16; Kerfoot & Joo, *supra* note 12.

[116] Dworkin & Hait, *supra* note 11, at 101; Loyens & Loeff, *NAV Facilities: A Strategic Tool,* Loyens & Loeff Insights (June 9, 2023) https://www.loyensloeff.com/insights/news--events/news/nav-facilities-a-strategic-tool/ [https://perma.cc/T325-CU2A]. "Hybrid" facilities have also emerged which combine subscription facilities and NAV Debt facilities, and are therefore

the value of all the portfolio companies owned by the fund, distinguishing it from the acquisition finance seen in traditional LBOs which is only backed by the value of the assets for which the loan is being used to acquire.[117]

NAV Debt can take the form of either a term or revolving credit facility.[118] 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.[119] A lender will assess the amount of debt it is prepared to lend based upon an "advance rate,"[120] 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).[121] 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.[122] The lender may also insist that the net asset value be discounted to account for the relative illiquidity of the assets.[123] 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.[124] Lender diligence of the portfolio will therefore be extensive.[125] 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.[126]

It would appear that advance rates on NAV Debt are typically in the 10-30% range,[127] giving a lender substantial headroom on the "loan to value"

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upward- and downward-looking. Leung & Balasubramanian, *supra* note 10; Dworkin & Hait, *id.*, at 104; Loyens & Loeff, *id.*

[117] *Supra* note 76 and accompanying text.

[118] Lynch & Texeira, *supra* note 69.

[119] Bowen et al., *supra* note 115.

[120] *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 INISGHTS (July 29, 2013) https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2013/07/net-asset-value-credit-facilities/files/mayer_brown_net_asset_value_credit_facilities/fileattachment/mayer_brown_net_asset_value_credit_facilities.pdf [https://perma.cc/LD37-TLPR]; Vittorio Casamento, *Navigating the Growth of NAV and Hybrid Facilities in Funds Finance*, NORTON ROSE FULBRIGHT THOUGHT LEADERSHIP (June 2023), https://www.nortonrosefulbright.com/es-mx/knowledge/publications/4ea5bea9/navigating-the-growth-of-nav-and-hybrid-facilities-in-funds-finance [https://perma.cc/T67Q-J3QP].

[121] See Stephenson & Jones, *supra* note 13.

[122] Bazar et al., *supra* note 120.

[123] *Id.*

[124] *Id.*; Leung & Balasubramanian, *supra* note 10; Dworkin & Hait, *supra* note 11, at 101; Bowen et al., *supra* note 115.

[125] Leung & Balasubramanian, *supra note 10*; Loyens & Loeff, *supra* note 116.

[126] Lynch & Texeira, *supra* note 69; Dworkin & Hait, *supra* note 11, at 101; Bowen et al., *supra* note 115.

[127] Lynch & Texeira, *supra* note 69.

(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[128] and others noting that for larger funds, NAV Debt can have an LTV less than 10%.[129] Since the NAV Debt is subordinated to acquisition debt,[130] 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.[131] 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 fund's 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.[132]

B. *Fund-Level and Portfolio Company-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.[133] Some vintage funds, maintaining strict adherence to the rules of private equity LBOs, do not even permit subscription facilities.[134] 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.[135]

If the fund cannot directly borrow NAV Debt, it can incorporate an SPV (the "NAV SPV") as the borrower.[136] The use of a NAV SPV does not contravene prohibitions on the fund itself incurring debt. Ideally, from the lender's perspective, the fund then guarantees the debt and obligations of the NAV SPV.[137] However, if the fund's limited partnership agreement includes

[128] Thomas Doyle, *Pemberton Asset Management: Why LPs are Warming to NAV Financing*, Private Debt Investor (Oct. 2, 2023), https://www.privatedebtinvestor.com/pemberton-asset-management-why-lps-are-warming-to-nav-financing/ [https://perma.cc/8TU7-MNT7]; Financier Worldwide, *supra* note 19 (noting that a Deloitte study had the range at 25-30%).
[129] Kerfoot & Joo, *supra* note 12.
[130] *See Infra* note 145 and accompanying text.
[131] Lynch & Texeira, *supra* note 69.
[132] *Id.*; Bowen et al., *supra* note 115.
[133] *See* supra note 69 and accompanying text.
[134] Dworkin & Hait, *supra* note 11, at 101; Bazar et al., *supra* note 120.
[135] Lynch & Texeira, *supra* note 69.
[136] Kerfoot & Joo, *supra* note 12; Loyens & Loeff, *supra* note 116.
[137] Kerfoot & Joo, *supra* note 12; Lynch & Texeira, *supra* note 69.

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[138] (although the wording of some fund agreements may effectively proscribe even equity commitment letters).

Once the NAV SPV has been incorporated, the fund's shares in the holding companies (topcos[139]) 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.[140] With some structures, a second SPV, wholly-owned by the NAV SPV, may also be established to optimize the security package, inserted between the NAV SPV and the topco holding entities.[141] The NAV Debt therefore sits above the umbrella of portfolio company silos and the SPV becomes a holding company for all of the fund's interests.

The NAV SPV structure is shown in Figure 2, and if a guarantee or equity commitment letter is provided by the fund, 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. Even without a guarantee or equity commitment letter, the NAV Debt structure compromises the free flow of distributions from portfolio company returns to the fund,[142] since, unless specifically permitted in the NAV Debt credit facility, the lender of the NAV Debt will not permit distributions to the fund from the NAV SPV without its consent while the NAV Debt is outstanding.[143]

Since the NAV SPV is further up the chain and further from portfolio company assets than the bidcos which have incurred acquisition debt,[144] the NAV Debt is structurally subordinated to the acquisition debt for each portfolio company.[145] 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.

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[138] Kerfoot & Joo, *supra* note 12.

[139] *See* text accompanying *supra* notes 72–75.

[140] Kerfoot & Joo, *supra* note 12.

[141] Dworkin & Hait, *supra* note 11, at 102 (noting that NAV Debt provided to funds-of-funds commonly utilizes a second SPV, wholly-owned by the first borrower SPV, to hold the equity in the topcos).

[142] *See* text between *supra* notes 63–64.

[143] *See infra* notes 162–64, 168–69 and accompanying text.

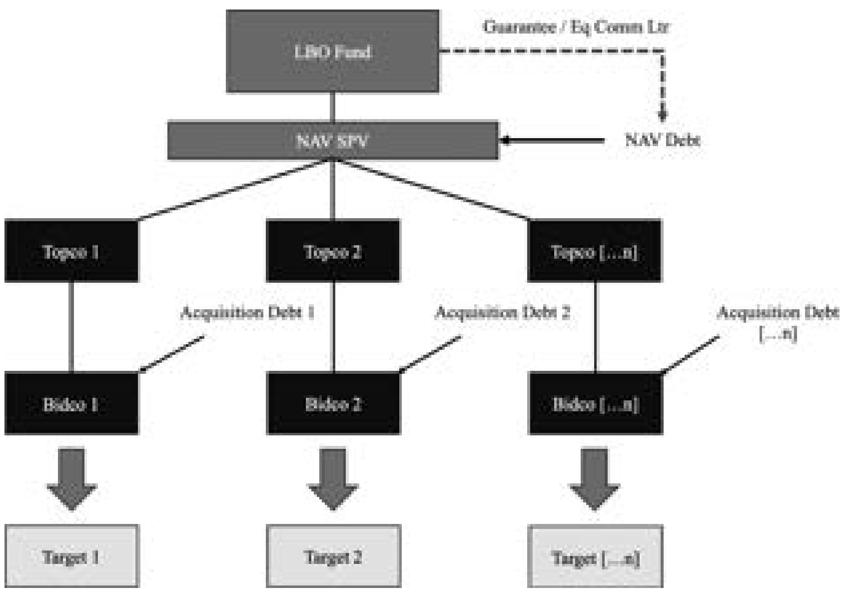
[144] *Supra* note 75 and accompanying text.

[145] Lynch & Texeira, *supra* note 69.

C. Collateral

NAV Debt is usually secured,[146] but private equity is nothing if not complicated. Given that NAV Debt is lent against the net asset value of the portfolio companies of the fund, ideally 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.[147] The acquisition finance facilities will inevitably include "negative pledge" provisions which prohibit the portfolio companies from pledging their assets as security for other debt.[148] 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.

FIGURE 2: NAV DEBT BORROWING STRUCTURE



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.[149] If possible,

[146] Bazar et al., *supra* note 120; *see also* Lynch & Texeira, *supra* note 69 (however, noting that some established sponsors of funds owning high-quality assets may be able to obtain unsecured NAV Debt).
[147] *See supra* note 145 and accompanying text.
[148] Hutchinson & Lawrence, *supra* note 76, at 104; *see also* Kerfoot & Joo, *supra* note 12.
[149] Lynch & Texeira, *supra* note 69; *see also* Bazar et al., *supra* note 120.

the fund, the NAV SPV, or a wholly owned subsidiary of the NAV SPV, as the case may be, will pledge the shares it owns in each of the topcos to the NAV Debt lender.[150] 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.[151] Two complications make such security problematic to implement in practice. First, change of control provisions may pervade the downstream documents.[152] 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 transfers to a non-affiliate of the fund.[153] Therefore, upon enforcement of the security over the shares of each topco by the NAV Debt lender, all the acquisition finance facilities lower down the chain could become repayable. Furthermore, well-drafted clauses will provide that even the mere action of pledging shares in topco, or a NAV SPV owning the shares in topco, in favor of a third party could also be deemed to be a change of control.[154] 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.[155] Further complicating the picture, change of control provisions may also be prevalent in commercial contracts of the portfolio companies.[156]

The second material issue revolves around the equity documents of the various topcos. The constitutional documents and stockholders' agreements of those companies will include minority investor protections in favor of portfolio company managers in their capacities as topco shareholders.[157] 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.[158] However, managers will seek contractual protections to prevent them from involuntarily becoming beholden to a new master upon a change in the majority owner of topco equity, including tag-along rights allowing them to force an acquirer of a majority of shares to acquire their shares at the same price.[159] 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,

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[150] *See id.*
[151] Loyens & Loeff, *supra* note 116.
[152] Lynch & Texeira, *supra* note 69; *see also* Bazar et al., *supra* note 120.
[153] *See id.*; Loyens & Loeff, *supra* note 116.
[154] Lynch & Texeira, *supra* note 69.
[155] Loyens & Loeff, *supra* note 116; *see also*. COOKE, *supra* note 114, 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).
[156] Bazar et al., *supra* note 120.
[157] Loyens & Loeff, *supra* note 116.
[158] *See* text accompanying *supra* notes 105–07.
[159] Loyens & Loeff, *supra* note 116.

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.[160] In such a case, there will often 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.[161]

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.[162] Furthermore, the NAV SPV and the fund will be required to place any distributions from portfolio companies into a ring fenced account that will be pledged to the NAV Debt lender.[163] 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.[164] LTV thresholds are discussed in the next sub-section.[165]

NAV Debt therefore breaks the rules of the traditional private equity LBO model—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 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, unless cured, require the fund to pay back the entire sum of the debt. The principal financial covenant in a NAV Debt package will be an LTV threshold, specifying that the LTV cannot

[160] Jenkinson et al., *supra* note 28, at 12.

[161] 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/ [https://perma.cc/XE8Z-M9RG].

[162] Lynch & Texeira, *supra* note 69; Loyens & Loeff, *supra* note 116; Bazar et al., *supra* note 120; Casamento, *supra* note 120.

[163] *Id*.

[164] Bazar et al., *supra* note 120; Dworkin & Hait, *supra* note 11, at 101 (describing the "borrowing base"). Also, *see* text accompanying *infra* notes 168–69.

[165] *See infra* "Part III.D: *Financial Covenants and Interest*".

fall below a certain level.[166] 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.[167] 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.[168] 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.[169]

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, but the acquisition finance documents themselves may also include cash sweep provisions[170] 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 compound interest is payable going forward on the increased principal), and 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.[171] 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.[172] The interest rate may be fixed or floating tied to a standard

[166] Leung & Balasubramanian, *supra* note 10; Loyens & Loeff, *supra* note 116.

[167] Dworkin & Hait, *supra* note 11, at 101, 104.

[168] Robin Blumenthal, *NAV Finance: "A Huge and Growing Area"*, PRIVATE DEBT INVESTOR (February 2, 2023), https://www.privatedebtinvestor.com/nav-finance-a-huge-and-growing-area/ [https://perma.cc/6FCS-NLAG]; Lynch & Texeira, *supra* note 69.

[169] Lynch & Texeira, *id.*; Bowen et al., *supra* note 115; Jenkinson et al, *supra* note 28, at 30 (by analogy to cash-sweep provisions in acquisition debt).

[170] Jenkinson et al, *supra* note 28, at 30.

[171] Louch et al., *supra* note 15.

[172] *Id.*

interbank base rate.[173] 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*.[174] 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 prevalent, it is a continually evolving asset class. However, the uses of NAV Debt are becoming well known in the industry, to which this Article turns 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. This Part classifies those uses into three broad categories—offensive, defensive, and liquidity— and outlines 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[175] and is arguably the most benign form of NAV Debt. The relevant investment could be the acquisition of a new portfolio company[176] or a "bolt-on" investment,[177] 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.[178] It has been noted that with exit values depressed,[179] vintage private equity funds are finding it challenging to divest of investments at a satisfactory price prior to the maturity of the portfolio company level debt

[173] Bucak, *supra* note 16 (suggesting that floating rate NAV Debt interest is more common); Louch et al., *supra* note 15 (same); Blumenthal, *supra* note 168 (same).

[174] Bowen et al., *supra* note 115.

[175] Dworkin & Hait, *supra* note 11, 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).

[176] Kerfoot & Joo, *supra* note 12.

[177] Leung & Balasubramanian, *supra* note 10; Loyens & Loeff, *supra* note 116; Joe Robinson, *NAV Financings – Key Tax and Structure Considerations*, Macfarlanes In Depth (October 11, 2023), https://www.macfarlanes.com/what-we-think/2023/nav-financings-key-tax-and-structure-considerations/ [https://perma.cc/AEJ2-JWPK]; McElhaney, *supra* note 18 (suggesting that bolt-ons are the most common use case for NAV Debt).

[178] Lynch & Texeira, *supra* note 69; Doyle, *supra* note 128.

[179] *Infra* notes 215–16 and 222–24 and accompanying text.

used to acquire the relevant company.[180] 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.[181] In 2010, the average was only 3.8 years.[182] Longer holding periods will start to bump up against maturity terms for acquisition finance—usually in the region of 5–7 years.[183] If exit values are low, the fund may consider it more beneficial to refinance the acquisition debt rather than selling the investment, since although leveraging an investment can enhance returns if the fund exits an investment at a profit,[184] the reverse is true when the fund makes losses.[185] 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 only 40%. Accordingly, refinancing the acquisition debt may be preferable to selling a portfolio company at a loss. Rather than "re-upping" 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.[186] 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 a willingness 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.[187] Most obviously, this will assist funds when seeking to refinance existing acquisition debt,[188] particularly with the trend in interest rates in recent years. Between 2009 and 2016, U.S. federal funds interest rates were historically

[180] 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 [https://perma.cc/LXG7-XA3P]; McElhaney, *supra* note 18.

[181] 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/market-intelligence/en/news-insights/articles/2023/11/private-equity-buyout-funds-show-longest-holding-periods-in-2-decades-79033309 [https://perma.cc/62BM-JUTW].

[182] Financier Worldwide, *supra* note 19.

[183] Hutchinson & Lawrence, *supra* note 76, at 89; Gara & Platt, *supra* note 180.

[184] *See supra* Part I.C.

[185] *See* Rasmussen, *supra* note 24; Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 Wash. U. L. Rev. 907, 923 n.74 (2023).

[186] Gara & Platt, *supra* note 180.

[187] Kerfoot & Joo, *supra* note 12; Lightbrown, *supra* note 16; Louch et al., *supra* note 15 (noting that the current economic climate means that "refinancing at the individual asset's level is more expensive and difficult"); *but see* Bucak, *supra* note 16 (noting that interest on NAV Debt has gone as high as 20%).

[188] Financier Worldwide, *supra* note 19.

low at near-zero rates.[189] 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, causing the federal funds rate to reach 5.5% in July 2023.[190] As of February 2025, the effective federal funds rate was still in the range of 4.25%–4.5%,[191] much higher than the rates seen during the 2010s. Accordingly, when the relevant portfolio company was acquired, interest rates may have been far lower and the discounted cash flow basis on which the portfolio company was valued at acquisition will have been based upon interest rates prevalent in the market at the time.[192] 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 be 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 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 increases in rates in 2021 and 2022.[193] It has also been challenging for those banks to syndicate those loans which become stuck on their balance sheets, making them reluctant to re-enter the risky LBO market.[194] Funds could tap the more costly private credit market for acquisition debt,[195] but another cheaper option for a fund is to borrow NAV

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[189] Nick Timiraos, *Fed to Signal It Has Stomach to Keep Rates High for Longer*, Wall St. J. (April 30, 2024), https://www.wsj.com/economy/central-banking/federal-reserve-meeting-interest-rates-inflation-6dcb05e8 [https://perma.cc/2M2S-DC9J].

[190] *Id.*

[191] Data from: Federal Reserve Bank of New York, https://www.newyorkfed.org/markets/reference-rates/effr [https://perma.cc/29LR-SGS3].

[192] Bobby V. Reddy, *Deconstructing Private Equity Buyout Valuations*, 8 J. Bus. L. 629, 642, 645, 647 (2022) (discussing the discounted cash-flow valuation 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 target's overall valuation).

[193] Jill R. Shah & 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 [https://perma.cc/62TH-UDES].

[194] Stephen Gandel, et al., *Big Banks Sit Out LBO Rebound After Being Stung by Earlier Buyouts*, Fin.Times (October 8, 2023), https://www.ft.com/content/8962a5cc-2c4c-4e18-801c-9ad4e342f1fd [https://perma.cc/SM2Y-VBA6].

[195] *Id.*

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[196]—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.[197] 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.[198] 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 than to service regular cash interest payments that would otherwise be payable if the investment were made by extending the existing acquisition debt.[199]

NAV Debt may also be used on acquisitions and bolt-on investments instead of, or supplementing, limited partner capital commitments.[200] In such cases, the relevant acquisition will be completed partly with acquisition debt at the portfolio company level and partly with NAV Debt substituting for 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 phases but are only permitted to draw down on capital commitments from limited partners during that investment phase.[201] 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.[202] Taking advantage of dislocated asset values will, of course, drive such behavior. Additionally, a fund may use NAV Debt during its investment phase 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

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[196] Kerfoot & Joo, *supra* note 12.

[197] Gara & Platt, *supra* note 180; Lynch & Texeira, *supra* note 69.

[198] Paolo Pasquariello, *Financial Market Dislocations*, 27 REV. FIN. STUD. 1868, 1868 (2014).

[199] While PIK interest may be implemented for offensive NAV Debt to make bolt-on investments, NAV Debt utilized to acquire a fresh portfolio company or to completely refinance and replace acquisition debt will likely employ cash interest, since there will be no underlying acquisition debt restricting distributions to pay interest on the NAV Debt.

[200] Lynch & Texeira, *supra* note 69; Loyens & Loeff, *supra* note 116.

[201] *Id.*

[202] Lynch & Texeira, *supra* note 69.

capital is at risk before exit returns are distributed, the higher the internal rate of return (IRR) for those limited partners.[203] 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 successor 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.[204] Further, as discussed below, if the hurdle rate is calculated based upon IRR, such an approach allows the general partner to accelerate the receipt of its carry.[205]

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.[206] 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 under the acquisition finance documents, cure the relevant default under the underlying debt.[207] 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.[208] As equity, the contributions are therefore legally subordinated to the underlying acquisition debt, which will be required under the acquisition debt facility documents.

In addition, although acquisition debt refinancings were cast in terms of offensive NAV Debt above,[209] it would appear that most NAV Debt refinancings are a result of portfolio companies failing to pay interest on acquisition debt and, therefore, more defensive in nature.[210] 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.[211]

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[203] *See* Jenkinson, *supra* note 28, at 14; *see also* Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. Econ. Persp. 147, 162 (2009).

[204] *See infra* text accompanying notes 286–88.

[205] *See infra* text accompanying note 289.

[206] *See* Loyens & Loeff, *supra* note 116; *see also* Lynch & Texeira, *supra* note 69 (describing defensive NAV Debt as "principal-protecting").

[207] *See* Lynch & Texeira, *supra* note 69.

[208] The underlying acquisition facility documents will include restrictions on the incurrence of further debt by topco, bidco, and the relevant portfolio companies without acquisition debt lender consent, meaning that the NAV Debt cannot contributed down the chain as debt.

[209] *Supra* note 178 and accompanying text.

[210] *See* Gara & Platt, *supra* note 180.

[211] *Id.*

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 potential bankruptcy and bet upon its performance improving over the longer term and creating returns for the fund. Outside the fund's investment phase, 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 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.[212]

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 for what any recalled distributions can be used and the period during which the distribution remains recallable.[213] Although "recallable provisions" do suffuse the market, it appears that it is unusual for such recalls to be triggered by general partners in practice.[214]

The contemporary driver for liquidity NAV Debt stems from a moribund exits market.[215] 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.[216] Consultancy firm Bain & Co. has described how buyout firms have a "towering backlog" of companies to exit.[217] 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.[218] The discounted cash flow valuation basis on which those portfolio companies were acquired would have reflected low costs of debt leading to private equity acquirers willing to pay higher purchase prices without, so they thought,

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[212] *See* Kerfoot & Joo, *supra* note 12; *see also* Lynch & Texeira, *supra* note 69; Robinson, *supra* note 177.

[213] Adam Le & Alex Lynn, *Recallable NAV Loans: The "Zero-Sum Game" Leaving LPs in a Bind*, PRIVATE EQUITY INT'L (Nov. 2, 2023), https://www.privateequityinternational.com/recallable-nav-loans-the-zero-sum-game-leaving-lps-in-a-bind/ [https://perma.cc/FZ4P-QJUY].

[214] *Id.*

[215] Financier Worldwide, *supra* note 19; Gara & Platt, *supra* note 180.

[216] PITCHBOOK, US PE BREAKDOWN 21 (Apr. 9, 2024) (showing 2024 being on track to match 2023); Gara & Platt, *supra* note 180; Louch et al., *supra* note 15.

[217] Gara & Platt, *supra* note 180.

[218] *Supra* notes 189–92 and accompanying text.

prejudicing the making of returns at least above the hurdle rate.[219] The unforeseen uptick in interest rates in recent years will have obliterated those historic valuations.[220] In a higher interest rate environment, potential acquirers, especially those using now costly debt financing (such as other private equity firms in secondary buyouts), are valuing companies more conservatively.[221] 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 2021 exit values.[222] A standoff or "logjam"[223] developed, with a pricing disconnect between private equity sellers seeking to crystalize investments and buyers willing to acquire them, exacerbated by the 2021 and early 2022 surge in deal volume.[224] The issue becomes particularly pertinent when the fund is under pressure to exit investments pending dissolution of the fund near the end of its lifetime.[225]

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."[226] Private equity funds have to either 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.

One option to ride out the period is to extend the life of the fund. As discussed, the fund's term can usually be extended at the sole discretion of the general partner for two or three years, and even longer with limited partner consent.[227] 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 consent to a further extension of the lifetime of the fund. However, an extended period without returns hammers the metrics on which limited partners have made their investments, and the general partner may not be able to secure consents for such an extension unless it makes distributions prior to the end of

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[219] *See supra* note 192; *see also* Gara & Platt, *supra* note 180.

[220] *Supra* notes 189–92 and accompanying text.

[221] Matt Wirz, *Move Aside, Big Banks: Giant Funds Now Rule Wall Street*, WALL ST. J. (Apr. 22, 2024), https://www.wsj.com/finance/investing/investment-funds-new-financial-supermarkets-9b8187d7 [https://perma.cc/S359-VV6G]; FINANCIER WORLDWIDE, *supra* note 19 (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).

[222] PITCHBOOK, *supra* note 216, at 21.

[223] *Id*. at 4.

[224] *Id*. at 21.

[225] *Supra* note 39 and accompanying text.

[226] David Wachter, as quoted in Rod James, *AXA Division Wagers On Private-Equity Shift*, WALL ST. J., B1-B2 (April 4, 2024).

[227] *Supra* note 37 and accompanying text.

the fund.[228] NAV Debt allows the general partner to make distributions to the limited partners detached from divestments of portfolio companies and therefore facilitates an extension of the holding period for portfolio companies. Investors are insulated from what they will hope is a temporary discounted portfolio company exit market and the sale of investments at bottom-of-the-market prices.[229]

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 modeling 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 phase of the fund.[230] 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. They would therefore be forced to sell their fund interests (with general partner consent) in the secondaries market.[231] 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,[232] with some seeing discounts as large as 25%.[233] Liquidity NAV Debt gives limited partners the possibility of liquidity at par[234] 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.[235]

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 on their maximum exposure to private equity and will model their

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[228] Cheffins & Armour, *supra* note 39, at 14.

[229] Robinson, *supra* note 177 (noting 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).

[230] Jenkinson, *supra* note 28, at 14.

[231] Cheffins & Armour, *supra* note 39, 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).

[232] Lightbrown, *supra* note 16.

[233] Carroll, *supra* note 21.

[234] *Id.* 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).

[235] Carroll, *supra* note 21; Lightbrown, *supra* note 16.

portfolio of investments on the basis of regular cash flow distributions over time[236]—without regular distributions, such investors will not have the liquid capital to invest in new funds established by the general partner.[237] That is a significant blow to the private equity model, since with finite lifetime funds, the continuing generation of profits for the private equity firm is dependent upon constantly establishing new funds.[238] 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.[239] Although total funds raised did tick upward in 2023,[240] it was concentrated within a handful of megacap funds, with limited partners consolidating what little cash they did have into blue chip private equity.[241] Figure 3b shows how liquidity NAV Debt can distribute the cash to limited partners that they can then recycle into new funds.[242] Furthermore, in much the same way as delaying drawdowns from limited partners,[243] returning capital to limited partners can increase 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, potentially impairing the fund managers' personal compensation. Liquidity NAV Debt in the face of a stagnant exits market may be rationally attractive for such fund managers.[244]

Whether offensive, defensive, or liquidity, NAV Debt can be conceptually beneficial to funds, private equity firms, and limited partners alike. Framed solely within that prism, NAV Debt would seem to 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.

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[236] *Supra* note 230 and accompanying text.

[237] Stephenson & Jones, *supra* note 13 (noting the "denominator effect" which hinders investors from investing in new funds until they have received distributions from investments in existing funds).

[238] Carroll, *supra* note 21; Pitchbook, *supra* note 216, at 21; Metrick & Yasuda, *supra* note 28, at 2304.

[239] Pitchbook, *supra* note 216, at 28.

[240] *Id*.

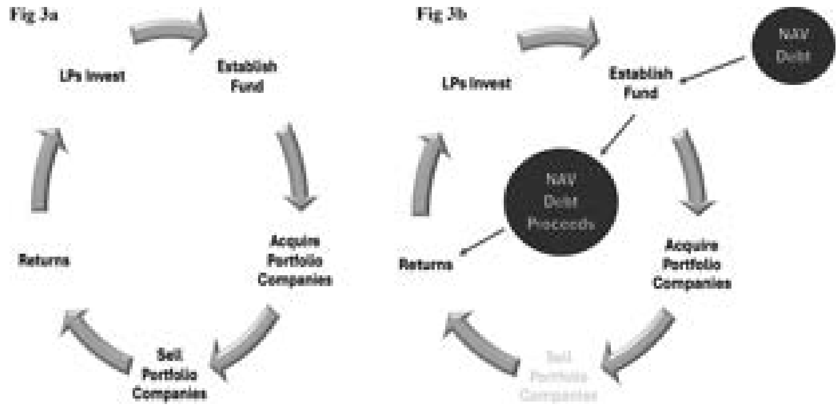
[241] Chris Witkowsky, *Texas Teachers' PE Chief on Focus on DPI, Shift to Smaller Market Funds*, Buyouts (December 28, 2023), https://www.buyoutsinsider.com/texas-teachers-pe-chief-on-focus-on-dpi-shift-to-smaller-market-funds/ [perma.cc/UN8E-V75J].

[242] Doyle, *supra* note 128 (noting how NAV Debt can support general partners in increasing commitments to future fund-raises).

[243] *Supra* note 203 and accompanying text.

[244] ILPA, *Enhancing Transparency Around Subscription Lines of Credit*, 1, 4 (June 2020) (analogizing to the use of subscription facilities to increase IRR).

FIGURE 3: PRIVATE EQUITY LBO LIFECYCLE



V. THE DETRIMENTS OF NAV DEBT

Notwithstanding the optimistic picture that has been painted, taking into account potential shocks to the traditional LBO fund and governance models described in Parts I and II, in this Part, we canvass the bleaker consequences of NAV Debt.

A. Contagion Risk

One of the rules of private equity is the siloing of investments, such that if one investment fails, the acquisition debt lenders can make claims only against the assets of that portfolio company.[245] NAV Debt, with 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.[246] In effect, poor investments contaminate the entire portfolio. That contagion risk can occur even if an asset does not "fail" completely into insolvency.

For example, take a $1 billion NAV Debt loan, incurred in July 2023 by an LBO fund with a net asset value of $5 billion spread across ten portfolio companies, each with a net asset value of $500 million. The initial LTV was therefore 20%. Let's assume an LTV financial covenant threshold of 25%,[247]

[245] *See* Part I.D of this article.
[246] Bucak, *supra* note 16.
[247] Accurate data on LTV thresholds in the nascent market is challenging to gauge. A recent submission by the British Venture Capital Association suggested that net asset value would

and a (possibly conservative)[248] PIK interest rate of 10% per annum. 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 approximately $1.21 billion—an LTV of 24.2%, bumping up against the LTV threshold.[249] However, consider circumstances where two portfolio companies performed poorly, although still sufficiently viable to pay acquisition debt interest and with those portfolio companies still showing positive net asset values. In a dramatic, but plausible, example, imagine that by July 2025 the net asset values of those two companies had each dropped 90% to $50 million (with the 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.[250] Selling the two poorly performing companies would generate $100 million, which would bring the LTV down only to 27.8%. Unless the fund can secure additional funding, to pay down the NAV Debt further, it will need to divest of healthy companies that would otherwise have longer term growth potential.[251] 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 to refinance such debt, in the current environment, that debt is likely costing far more than the acquisition debt originally incurred. The struggling portfolio company went into default on the cheaper acquisition debt, so certainly cannot service the more expensive NAV Debt, causing the healthier portfolio companies 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 clear any remaining acquisition debt but also pay the NAV Debt principle and accrued 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 across

generally have to fall by 33%-50% prior to a covenant being breached (BVCA, *Summary of BVCA Engagement with Bank of England on Financial Stability Considerations in Private Capital* (June 2024)).

[248] Louch et al., *supra* note 15 (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%). *See also* Bucak, *supra* note 16 ("interest rates on NAV loans in some cases going as high as 20%").

[249] Since NAV Debt more commonly employs a floating rate of interest, this example assumes that the federal funds rate has remained constant.

[250] *Supra* note 167 and accompanying text.

[251] Martinez, *supra* note 8; Gara & Platt, *supra* note 180.

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 selling at that time maximizes returns on the particular investment. Similarly, a fund may sit on a poorly performing asset rather than selling for fear that an exit would 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 previously have been obscured.[252] The unlimited liability of the general partner for the NAV Debt may also influence such cautious behaviors that minimize the risks of default on the NAV Debt.[253] Although the general partner itself is usually a limited liability shell entity,[254] the firm's carry could be at risk. 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

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. Consider liquidity NAV Debt and its interaction with the carry. Conceptually, as discussed, the carry has a role in reducing fund-level agency costs,[255] but in the world of NAV Debt, the carry may in fact drive agency cost-generating behavior. For a fund operating on a pure European waterfall model, a logjam in exits may impede the receipt of carry. Even if the relevant fund has divested a majority of its portfolio companies, it may not have returned all of the limited partners' capital and surpassed the hurdle rate. Alternatively, while the hurdle rate may have already been exceeded, the full extent of the carry cannot be realized until the remaining portfolio companies are sold. Although 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[256]—creating a misalignment of interests. 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.[257]

[252] Witkowsky, *supra* note 9; Cheffins & Armour, *supra* note 39, at 14.
[253] *Supra* note 31 and accompanying text.
[254] *Supra* note 34 and accompanying text.
[255] *Supra* note 91 and accompanying text.
[256] EQVISTA, *supra* note 51 (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 49 (same).
[257] Gara & Platt, *supra* note 180.

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 and selling the portfolio companies, 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,[258] the general partner has nothing to lose by pouring more resources into the portfolio company in the hope of turning around the investment rather than exiting or winding up the investment sooner. Since the general partner will not receive a carry as it is, taking actions that risk creating greater losses for the limited partners will not cause further losses for the general partner.[259] For limited partners, though, the NAV Debt will reduce returns on those, and possibly other, investments further, potentially turning a positive return (albeit under the hurdle rate) into a negative return. Although such behavior may be constrained to a degree by the reputational consequences for the private equity firm in the fundraising and debt markets,[260] doubts remain as to the efficacy of such reputational constraints.[261]

The management fee can also be a driver behind the use of NAV Debt, with one study pertinently finding that, on average, management fees constitute approximately twice as much as carry fees earned by a private equity firm over the lifetime of a fund.[262] Therefore, prioritizing maximization of the management fee (even over maximizing returns) may be in the interests of a general partner.[263] As discussed in Part I, it is common for the management fee to shift after the investment phase from a calculation based upon committed capital to remaining invested capital.[264] In the normal course, as assets are divested and distributions made to limited partners, the remaining invested capital falls, reducing the management fee received. Liquidity NAV Debt enables distributions to limited partners while delaying exits, thereby

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[258] 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).

[259] Magnuson, *supra* note 24, at 1871, 1874.

[260] Fontenay, *supra* note 78, 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).

[261] 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).

[262] Metrick and Yasuda, *supra* note 28, at 2328

[263] Morris & Phalippou, *supra* note 24, at 295.

[264] *Supra* note 45 and accompanying text.

keeping invested capital constant and squeezing the portfolio for continuing management fees.[265] 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 company into bankruptcy or 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.

Another motivation to incur liquidity NAV Debt may be to free up limited partner resources (by providing them with cash distributions) to invest in new funds that the private equity firm is establishing.[266] Even if those limited partners are not cash-strapped, they may have internal policies that prohibit them from allocating too much of their assets under management to private equity LBO funds. Where those limited partners are not receiving regular returns from LBO funds in which they are invested, those internal thresholds become more likely to be breached. Liquidity NAV Debt can reduce a limited partner's allocations to an existing fund, enabling further investment by that limited partner in a new fund. A conflict arises between the interests of the current fund and the interests of the private equity firm in ensuring the success of the next fund. Lumbering the fund with costly NAV Debt to safeguard the latest fundraising 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 may see NAV Debt as a costly and unnecessary means of freeing up cash resources when they may have other options to do so. For example, 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.[267] Indeed, as a senior investment executive of an LBO investor opined, "We don't want to pay a bank an eye-watering fee to get our cash back earlier."[268] 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 eventual 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.

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[265] Robinson & Sensoy, *supra* note 229, at 2791.

[266] *Supra* note 238 and accompanying text.

[267] Witkowsky, *supra* note 9; Josephine Cumbo, *Calpers to Invest More than $30bn in Private Markets*, FIN. TIMES (March 19, 2024) https://www.ft.com/content/57eb4fa4-16d5-43aa-bdee-2ffec736b31d [https://perma.cc/2EPQ-35U6] (reporting that recently the largest retirement fund in the U.S., CalPERS, resolved to borrow against its assets to fund further investments).

[268] Le & Lynn, *supra* note 213.

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,[269] it is now apparent that such private credit funds are also acting as NAV Debt lenders, taking advantage of the high-interest rate environment.[270] Conflicts of interest could arise. For instance, the private credit funds of two separate private equity firms may agree to lend NAV Debt to each other's LBO funds—the rationale being to generate lucrative NAV Debt returns on their private credit funds. It is even feasible that the same private equity firm could be acting as the NAV Debt lender and the LBO sponsor in the same fund.[271] If limited partners were to acquiesce to such an arrangement, 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.[272]

Even outside of the obvious conflicts created by such 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 instead to standardize the practice amongst LBO funds to enhance its private credit business.

A type of conflict that has proven to be less theoretical is where a private equity sponsor has a significant limited partner interest in an LBO fund it itself manages. As discussed, it is not uncommon for private equity firms to co-invest with limited partners to demonstrate skin in the game,[273] with some firms running a strategy where they derive a substantive portion of their returns not just from fees, but from large direct investments in their own funds as well. If the private equity 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 sponsored funds to distribute returns to itself as the largest investor in that fund, enabling it to make new investments elsewhere.[274]

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[269] Fontenay, *supra* note 91, at 1113.

[270] McElhaney, *supra* note 18.

[271] Henderson & Birdthistle, *supra* note 30, at 57; Fontenay, *supra* note 91, at 1114 (noting, by analogy, that private equity funds may invest in the debt and equity of the same portfolio company); Gara & Platt, *supra* note 180 (noting that, in 2023, an LBO fund of 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).

[272] Kastiel and Nili, *supra* note 88, at 1626 (explaining by analogy to continuation funds).

[273] *Supra* notes 92–93 and accompanying text.

[274] Louch et al., *supra* note 15.

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% of LBO fund limited partners raised misalignment as an issue, with only 8% considering such finance as alignment-enhancing.[275] However, as discussed next, disquiet regarding alignment not only results from private benefit extraction motivations, but also from the disruption of the governance mechanisms that otherwise serve investors well.

C. The Governance Challenges

In Parts I and II, 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.[276] 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. Therefore, NAV Debt interest will be more of a drag on returns than 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 otherwise would 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.[277] If offensive NAV 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. 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 bolt-on investments, covenants within the existing acquisition debt facility documents will, as discussed, necessitate NAV Debt PIK interest.[278] Managers of portfolio

[275] Witkowsky, *supra* note 9.
[276] *Supra* note 60 and accompanying text.
[277] *Supra* notes 109–12 and accompanying text.
[278] *Supra* notes 170–72 and accompanying text.

companies acquiring bolt-on investments will, assuming profitability, 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.[279] 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.[280] 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. While portfolio company-level lenders would not entertain such lending, 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 financing the acquisition. Of course, the interest must be paid back eventually, and the fund would be making the bolt-on 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 that limited partners in 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. What's more, if the anticipated growth in cash flow is not realized by the NAV Debt-financed, bolt-on investment, the contagion effect leads to other assets within the portfolio having to make up the shortfall.[281]

While it has already been discussed how NAV Debt could motivate greater risk-taking,[282] in other circumstances, it could encourage overly cautious behavior. 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. Often different teams within the private equity firm take 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

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[279] Of course, the incurrence of NAV Debt at the fund level may result in the private equity firm placing greater pressure on the managers to perform, but that pressure will be spread across the managers of all the portfolio companies across the fund's investments, since the prospects of the repayment of the NAV Debt is not solely tied to the performance of the company for which offensive NAV Debt was incurred.

[280] Talmor & Vasvari, *supra* note 1, at 4.

[281] *See* Part V.A of this article.

[282] *See* text between *supra* notes 257 and 259, and text between *supra* notes 280 and 281.

influenced by possible returns from those investments and the repayment of acquisition debt. NAV Debt delicately changes the dynamic. 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. Investment teams may come to different decisions on individual investments than would otherwise be made in the absence of NAV Debt. At an individual portfolio company level, greater caution may be exercised when a poor decision no longer simply diminishes the prospects of that portfolio company but also causes 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.

Finally, the use of liquidity or offensive NAV Debt for refinancings to delay exits could moderate the pressure on a fund to improve portfolio company profits rapidly—a governance advantage of private equity.[283] 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 separately from exits, and offensive NAV Debt facilitates the 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 relaxed. The mainstreaming of an exit delay option could be another subtle tweak in private equity governance that may compromise the performance of the asset class as compared with 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 of a general partner's use of NAV Debt to potentially exaggerate certain performance metrics of the fund.

The ongoing performance of a fund's general partner can be assessed under a variety of metrics. IRR is one obvious method of appraisal, and the most common when marketing new funds.[284] Additionally, "distributed to paid-in capital" ("DPI")—all distributions made to limited partners expressed as a multiple of the capital paid into the fund—will give limited partners a measure

[283] *See supra* text accompanying notes 97–98.
[284] Fontenay, *supra* note 91, at 1121.

of how quickly distributions are made after capital contributions ("cash-on-cash" value).[285]

By shortening the period of time over which limited partner paid-in contributions remain outstanding, liquidity NAV Debt—and, when incurred to avoid drawing down on limited partner commitments, offensive and defensive NAV Debt—can increase IRR and DPI by either increasing distributions in the case of liquidity NAV Debt, or reducing paid-in capital in the case of offensive and defensive NAV Debt.[286] Accordingly, general partners struggling through the exit logjam of recent years[287] may see real benefit in improving their performance benchmarks through NAV Debt without any corresponding improvement in the net asset values of investments. This is especially the case if it is currently also fundraising for new funds and needs to embellish its credentials for marketing purposes in comparison to competitor funds with similar liquidity constraints.[288] Additionally, if the carry hurdle is based upon an IRR calculation, as is common,[289] improving that metric eases the receipt of the carry. General partners may also be motivated to improve IRR to indulge the fund managers of certain limited partners whose personal remuneration may be based upon their individual annual (or quarterly) IRR performance across investments.[290] This would be more likely where those limited partners are "core", regular investors in the private equity sponsor's funds. All those improvements in performance metrics are at the expense of NAV Debt interest eating into ultimate returns, and the contagion risk of cross-collateralization.[291]

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 fundraising.[292] There is possibly more correlation between the final performance of a predecessor fund and successor fund performance, but since successor fundraising commonly occurs prior to the end of the predecessor fund, those final performance

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[285] Richard Lehman, *Distributed to Paid-In Capital (DPI)*, MOONFARE (December 5, 2023) https://www.moonfare.com/glossary/distributed-to-paid-in-capital-dpi [https://perma.cc/RV9H-VDH4].

[286] *Supra* note 203 and accompanying text; Kerfoot & Joo, *supra* note 12.

[287] *See supra* text accompanying notes 215–26.

[288] Kerfoot & Joo, *supra* note 12.

[289] Fontenay, *supra* note 91, at 1121.

[290] *Supra* note 244 and accompanying text.

[291] Recallable liquidity NAV Debt (*see supra* text accompanying notes 213–14) creates further challenges for limited partners, since the fund's IRR improves even though distributions cannot be freely utilized and remain part of the limited partner's committed capital—a "zero-sum game" for limited partners. *See, e.g.*, Le & Lynn, *supra* note 213 (explaining that while recallable NAV Debt reduces an investor's contributed capital, it also increases its uncalled commitment).

[292] *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, 8, 15 (2023).

figures would not be known at the time of successor fundraising.[293] NAV Debt is another tool through which general partners can exaggerate interim performance.

It would, however, appear that limited partners are becoming wise to the manipulation game, as 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."[294] 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."[295]

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.[296] 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 for each purpose. Many existing fund limited partnership agreements do not contemplate the use of NAV Debt at all,[297] with distribution waterfalls and carry determinations treating distributions made through liquidity NAV Debt in the same way as any distribution made pursuant to the divestment of an investment. 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 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.[298] That lack of transparency

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[293] *Id*. at 10–11, 15.

[294] Witkowsky, *supra* note 241 (further noting that limited partners are also discounting returns from exits to continuation funds when scrutinizing the track record of general partners).

[295] Antoine Gara & Will Louch, *Private Equity Groups Face Investor Scrutiny Over Tactics for Returning Capital*, Fin. Times, Oct. 11, 2023, https://www.ft.com/content/a8a7f384-00ac-4cdf-9a54-c8fbc6b9db3d [https://perma.cc/SJ9X-JSJW].

[296] *Id*. (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 67, at 1 (noting, by analogy, the distortive effect of subscription facilities that makes "comparability of performance more challenging", with the use of fund-level debt increasing IRR but reducing the total value of the fund as a multiple of paid-in capital).

[297] *See* Le & Lynn, *supra* note 213. 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 185, 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").

[298] 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, on occasion NAV Debt has been incurred without disclosure to limited partners (with its existence only

can impede limited partners from taking NAV Debt into account when assessing general partner performance and determining whether carry payments are justifiable. Outside of the context of NAV Debt, the SEC recently attempted to enact rules—subsequently struck down by the courts[299]—that would have required 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.[300] 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.[301] NAV Debt adds another layer of opaqueness to private fund operations.

VI. Recommendations and the Future of NAV Debt

A. *Recommendations*

Private equity firms and NAV Debt lenders make good conceptual cases for its incurrence, but as discussed in Part V, the underlying logic for NAV Debt and its consequences may deviate from the ideological business case. A backlash of sorts has emerged amongst limited partners. For example, with respect to more controversial uses, such as liquidity NAV Debt, the President of the Institutional Limited Partners Association ("ILPA"), an industry body for fund investors, stated, "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."[302] Although limited partners appear to be slightly more sanguine with regard to more benign uses of NAV Debt, such as offensive

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discovered after-the-event from financial statements), while other general partners have taken the view that they should first obtain LPAC consent. Fund-of-funds advisor, Hamilton Lane, recently suggested that 20% of fund agreements do not expressly require LPAC consent for the incurrence of NAV Debt. Selin Bucak, *Why Hamilton Lane Hates NAV Loans*, Citywire (Mar. 7, 2024), https://citywire.com/selector/news/why-hamilton-lane-hates-nav-loans/a2437718 [https://perma.cc/7Q29-UNHW].

[299] Peter Rudegeair & Matt Wirz, *Court Hands Private Equity, Hedge Funds a Win on SEC Fee Rules*, Wall St. J. (Jun. 5, 2024), https://www.wsj.com/finance/regulation/court-hands-private-equity-hedge-funds-a-win-on-sec-fee-rules-3676cc99 [https://perma.cc/HHH6-D9GZ].

[300] *See* 17 CFR 275.211(h)(1)-2; 17 CFR 275.206(4)-10. For a critique of the struck-down proposals, *see generally* William Clayton, *High-End Securities Regulation: Reflections on the SEC's 2022-23 Private Funds Rulemaking*, 14 Harv. Bus. L. Rev. 71 (2024).

[301] SEC, *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews: Final Rule*, Release No. IA-6383 1, 16–18 (Aug. 23, 2023).

[302] Tom Auchterlonie, *ILPA's Prunier: "Vast Majority" of LPS Unsupportive of NAV Loans*, Private Debt Investor, Apr. 2, 2024, https://www.privatedebtinvestor.com/ilpas-prunier-vast-majority-of-lps-unsupportive-of-nav-loans/ [https://perma.cc/62BH-U3QX].

NAV Debt for bolt-on investments,[303] even then, a senior director of the ILPA exclaimed that the "vast majority" of limited partners do not support using NAV Debt.[304] What then can be done? In the current generation of funds, limited partners may be "stuck" as the limited partnership agreements are "done deals" and often do not even contemplate NAV Debt. However, for new fundraisings, limited partners have the opportunity to seek protections. In the early publicly available working paper of this article, I made various recommendations for limited partners to follow.[305] Since then, the ILPA has provided NAV Debt guidance for limited partners and general partners,[306] following many of the recommendations I initially proposed. The recommendations I originally submitted are outlined in this Part VI.A, along with references to the similar guidance provided by the ILPA where applicable.

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 when negotiating limited partnership agreements to stipulate that limited partner consent is required prior to the incurrence of NAV Debt. 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.[307] Where conflicts between limited partners 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 NAV Debt-generated distributions or for IRR to be increased to satisfy the personal remuneration targets of fund managers, while other limited partners may be content to await exits. In such cases, it is unfair that costly debt is incurred right across the whole fund affecting all limited partners, when those limited partners, desperate for distributions, could sell in the secondaries market[308] or procure limited partner financing themselves.[309] 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

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[303] A survey carried-out by a leading advisor of NAV Debt lenders found that limited partners were more supportive of NAV Debt to finance bolt-on investments and refinance acquisition debt, but they displayed greater negative reactions to liquidity NAV Debt and offensive NAV Debt to make new portfolio company acquisitions. Rede Partners, *NAVigating NAV Financing*, 1, 3–4 (Jun. 2024).

[304] Auchterlonie, *supra* note 302.

[305] *See* Bobby V. Reddy, *Private Equity and Net Asset Value Loans–Ticking Time Bomb or Ticking All the Right Boxes?* 1–57 (ECGI Working Paper No. 805, 2024), https://ssrn.com/abstract=4838394 [https://perma.cc/4SB4-7DG6].

[306] *See* ILPA, *NAV-Based Facilities: Guidance for Limited Partners and General Partners* (2024).

[307] Even then, some limited partner fund managers may benefit from indirectly increased IRR from such NAV Debt. *Supra* note 244 and accompanying text.

[308] *Supra* note 231 and accompanying text.

[309] *Supra* note 267 and accompanying text.

don't get a say."[310] 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.[311] 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.

The ILPA's recent guidance does not go as far as the recommendation above. The ILPA recommends that general partners seek LPAC consent for liquidity NAV Debt incurrence in all circumstances, but for other forms of NAV Debt, they should seek LPAC consent only to the extent that the limited partnership agreement does not already permit the incurrence of NAV Debt generally.[312] Indeed, as expressed above, it is salutary to treat liquidity NAV Debt differently from more benign forms. However, not requiring at least LPAC consent for the incurrence of all NAV Debt, whether or not the limited partnership agreement permits NAV Debt generally, fails to recognize the context-dependent underlying rationales for the use of NAV Debt. An offensive or defensive NAV Debt package may on its face seem innocent and in the interests of the limited partners, but, as discussed in Part V, in certain circumstances, it could be driven by private benefits or could disrupt the governance mechanics that are otherwise conducive to driving returns.[313] Even LPAC consent being required for conflicts, which is common,[314] would not be sufficient where the relevant conflicts can be so opaque.[315] Accordingly, limited partners should consider negotiating: (i) LPAC consent rights for all forms of NAV Debt; and (ii) potentially a form of limited partner consent beyond simple LPAC consent for those forms of NAV Debt where conflicts could more obviously exist between limited partners, such as with liquidity NAV Debt.

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[310] Bucak, *supra* note 16.

[311] *Supra* note 89 and accompanying text.

[312] ILPA, *supra* note 306, at 13.

[313] For example, offensive NAV Debt for a refinancing (rather than selling the portfolio company) or defensive NAV Debt may be primarily driven by a desire to maintain the level of the management fee, particularly where the market conditions for an exit are in fact healthy (*supra* note 265 and accompanying text). Offensive NAV Debt could also be used to acquire an early-stage bolt-on investment, changing the parameters of the private equity business model (*see* text between *supra* notes 280-281). Furthermore, where the fund employs an American waterfall and a portfolio investment seems unlikely to be successful, a defensive NAV Debt Hail Mary may well not be in the interests of the limited partners (*see* text between *supra* notes 258–59). In each case, the merits of the NAV Debt will be dependent upon the factual circumstances at the time of incurrence, and a broad enabling provision in the limited partnership agreement without further LPAC consent could prejudice limited partner interests.

[314] *See, e.g.,* ILPA, *supra* note 306, at 19. Generally, LPAC consent will be required under limited partnership agreements to waive general partner conflicts on interest in any case.

[315] For example, a motivation to normalize NAV Debt within the private equity LBO industry as discussed in Part V.B above.

Disclosure provisions are also crucial, especially since studies have found that unless requirements are contractually recorded, limited partners receive very little fund information,[316] and private equity firms have incentives to conceal unfavorable information.[317] Therefore, limited partners should consider insisting on limited partnership agreement provisions that 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 structure and terms of the NAV Debt (including covenants and security), the reasons for its intended uses, any conflicts of interest with the lender, and consequences from a fund performance and fees perspective. In the case of liquidity NAV Debt, limited partners should request disclosure of any concurrent fundraisings by the private equity firm, 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. For any NAV Debt, a reasonable request in the limited partnership agreement would be to require the general partner to disclose to limited partners the same fund performance information provided to NAV Debt lenders, including net asset valuations and acquisition debt maturities. The ILPA has, in its NAV Debt guidance, recommended similarly broad disclosures.[318]

If the SEC's proposed rules—which would have required LBO funds to disclose quarterly information on fees, expenses, and fund performance[319]—had not been struck down by the courts,[320] the SEC could also have had a significant role to play on NAV Debt disclosure. Under the proposals, computations would have had to have been made "with and without the impact of any fund-level subscription facilities,"[321] since, as rationalized by the SEC, 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.[322] Similar accusations could also be levied at NAV Debt, and if the proposals had proceeded, an effective revision would have been to provide that performance metrics must be given without the impact of *any* fund-level debt or debt for which the fund has repayment liabilities, such as NAV Debt. Even without formal regulation, it would be prudent for limited partners to insist that performance statements disclose performance with and without the impact of subscription facilities and NAV Debt. However, as William

[316] Fontenay & Nili, *supra* note 185, at 978; Magnuson, *supra* note 24, at 1882–83; Clayton *supra* note 81, at 81.
[317] Magnuson, *supra* note 24, at 1862, 1882–83.
[318] ILPA, *supra* note 306, at 13, 21–22.
[319] 17 CFR 275.211(h)(1)-2.
[320] Rudegeair & Wirz, *supra* note 299.
[321] 17 CFR 275.211(h)(1)-2(e)(2)(ii).
[322] SEC, *supra* note 301, at 128-29.

Clayton has noted, various factors can lead to bargaining inefficiency and the breakdown of optimal private ordering when limited partnership agreements are negotiated,[323] especially where there are coordination problems between limited partners[324] or the general partner has bargaining leverage in circumstances where limited partners are desperate to be allocated participation in a particular fund.[325] Regulatory imposition of disclosure requirements in this ambit would have been welcome in the context of NAV Debt.

A thorny issue is fees. NAV Debt can distort the calculation, and accelerate the receipt, of fees. Distribution waterfalls in limited partnership agreements should, going forward, 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 to determine whether they would trigger 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 liquidity NAV Debt. The carry has not crystallized 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 to provide in the limited partnership agreement that the carry "generated" in such circumstances 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 phase, the intention is that the management fee be calculated based on remaining invested capital rather than capital commitments, a sensible approach when drafting the management fee provisions in a limited partnership agreement would be to deduct any liquidity NAV Debt incurred (including accrued interest) from the remaining invested capital when calculating the management fee post-investment phase. Such an approach would moderate the incentive on a general partner to utilize liquidity NAV Debt simply to augment the management fee. In its guidance, the ILPA has also noted the potentially troubling interactions between NAV Debt and fees and has recommended that limited partners raise pertinent questions in this regard in dialogue with general partners when a NAV Debt facility has been proposed.[326]

Finally, from a practical perspective, limited partners should 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

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[323] Clayton, *supra* note 300, at 93–98, 103–11.

[324] *Id*. at 104 (noting in particular the potential for limited partners to bargain for individualized benefits through side letters).

[325] *Id*., at 107, 115–16.

[326] ILPA, *supra* note 306, at 23.

of the actual overall performance of the fund and the ability of the general partner—a crucial consideration when determining whether to support a successor fund.

B. The Future of NAV Debt

Reports on the growth of NAV Debt and hyperbole as to its future dominance would suggest that NAV Debt could quickly become a mainstay of LBO fund structuring. However, there are numerous factions within the private equity industry with a horse in the race. This can lead to a degree of hubris when discussing NAV Debt, not least the lenders (including private credit funds) seeking returns, and general partners who can manipulate fund performance metrics, accelerate carry fees, and secure the success of new fundraisings. Ingrained interests incentivize a desire to normalize NAV Debt as a practical private equity tool. 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 succor to a desperate industry that made fund investments at a time of low interest rates during, what is now, a tough period of high interest rates, few exits, and fundraising challenges. 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 toolbox of general partners during times of economic turbulence, but the backlash from limited partners to liquidity NAV Debt, along with the contagion, governance, and conflict concerns that arise from all types of NAV Debt, will most likely lead to NAV Debt becoming rare in the normal course.

Even if the use of NAV Debt does not become prolific in the LBO fund world, NAV Debt will not completely disappear even during stable economic times. With respect to new funds with live limited partnership agreement negotiations, it will therefore be incumbent on limited partners to demand greater consent rights on NAV Debt, making its incurrence less straightforward than in prior vintages. The rabbit is out of the hat, and the latest cohort of limited partners should not be surprised by the concept of NAV Debt and should protect their interests accordingly. Whether they will in practice depends upon numerous variables, including, as discussed above, the bargaining position of individual limited partners, coordination challenges between limited partners, and how highly sought after are allocations in the relevant fund.[327] In the absence of a regulatory mandate, particularly in relation to disclosure, the ILPA's guidance may help embolden some limited partners to push for relevant protections. However, even then, limited partners should consider more robust provisions as discussed in this article. If limited partnership agreements evolve to include stronger, market-standard limited partner rights with respect to NAV Debt, the predicted rampant rise in the use of NAV Debt will be stymied further.

What of the current cohort of funds that appear to have embraced NAV Debt with gusto? Ultimately, it represents a gambit by private equity firms—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,[328] and if exit values do not improve, general partners will have lumbered their funds with expensive debt that doubles down on depressed returns. Even if mass uncurable events of default and lenders enforcing security are unlikely owing to the large LTV cushions adopted by lenders,[329] 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, existing 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. The jury is 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. Other funds, though, particularly those that 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 returns come the fund's end.

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[327] *Supra* notes 323–25 and accompanying text.

[328] Nick Timiraos, *Fed Cites Inflation Setback. Holds Rate Firm*, Wall St. J. (May 2, 2024), https://www.wsj.com/public/resources/documents/FQPOaEtBW38ss8UNfIky-WSJNewsPaper-5-2-2024.pdf [https://perma.cc/9YVC-QKH5] (suggesting that U.S. interest rates will remain higher for longer than originally envisioned by financial markets)

[329] Blumenthal, *supra* note 168.

Cutting through the NAV Debt hype, 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 certain, though, is that the next time economic circumstances lead to widespread attempts to adopt NAV Debt, limited partners will be far more savvy.

Conclusion

Fund-level 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 the 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 traditional LBO model, conflicted behaviors by general partners, and the confusion NAV Debt brings when attempting to evaluate fund performance. While lenders and sponsors have been quick to eulogize the merits of NAV Debt for limited partners, reports intimate that the clamor from limited partners for NAV Debt strategies is not as loud as those promoting the tool assert. 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 is 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 typical LBO model. A tool in the toolbox for times of economic shock 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 NAV Debt 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.