ESSAY

NET ASSET VALUE FINANCING AND PRIVATE EQUITY

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INTRODUCTION

Although not yet explored in the legal scholarship,[1] net asset value or "NAV" financing—debt generally[2] taken out at the fund level and secured

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1 A Lexis Nexis search of the category "law reviews and journals" on January 11, 2024, on each of the following terms produced zero results: "net asset value financing," "nav financing," and "nav finance."

2 "[T]he term 'NAV financing' is used generically in the market to refer to a number of different products." Matthew K. Kerfoot & Jinyoung Joo, *Key Drivers Behind Widespread Adoption of NAV Financing*, PROSKAUER ROSE LLP (Aug. 24, 2023), https://www.proskauer.com/pub/key-drivers-behind-widespread-adoption-of-nav-financing [https://perma.cc/QZP9-DS8Z]. The turn to NAV financing "to borrow against the equity value of their [private equity fund's] investments in operating/portfolio companies" is more recent. Meyer C. Dworkin & Samantha Hait, *The Continuing Evolution of NAV Facilities*, DAVIS POLK (Mar. 13, 2019), https://www.davispolk.com/insights/articles-books/continuing-evolution-nav-facilities [https://perma.cc/EYA9-9EBM]. NAV loans to private equity investors themselves (the limited partners) also exist but are, thus far, much less common. *See generally* Allison McNeely, *Private Equity*

against the net asset value of the fund's portfolio assets (or a subset thereof)—has taken off in the $8 trillion dollar[3] private equity realm.[4] Indeed, some forecast that its use will "be ubiquitous among private equity funds within the next five years"[5] and that the market size of this "esoteric product"[6]—will reach about $700 billion by 2030.[7] This Essay argues that the growth of this market is indicative of an important but understudied trend by legal scholars that is changing the private equity landscape: the increasing use of debt finance by private equity funds themselves.[8] It also suggests that while this leverage expansion has benefits, it also has potential drawbacks such as increased agency costs, intercreditor conflicts, and investor friction, and it risks financial market instability which is associated with leverage on top of leverage.

The NAV finance market's incursion into the private equity space blossomed during the COVID-19 pandemic, an economic environment in which exiting portfolio investments proved challenging and liquidity needs

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Investors Face Expensive Choice: 10% Loans to Get Cash, BNN BLOOMBERG (Sept. 29, 2023), https://www.bnnbloomberg.ca/private-equity-investors-face-expensive-choice-10-loans-to-get-cash-1.1978063 [https://perma.cc/SY5Z-DGKN]. For example, funds of funds have used NAV financing "to borrow against the value of limited partnership and other equity interests." Dworkin & Hait, *supra* note 2.

3 Laura Benitez, Silas Brown & David Ramli, *Large Backers of Private Equity Are Asking for Their Money Back*, BLOOMBERG (Jan. 12, 2024), https://www.bloomberg.com/news/articles/2024-01-12/blackstone-apollo-and-private-equity-rivals-face-calls-for-better-terms [https://perma.cc/KNN3-YKNR].

4 Sherri Snelson, *Fund Finance: Harnessing NAV Finance in New Ways*, WHITE & CASE INSIGHT (Aug. 5, 2021), https://www.whitecase.com/insight-our-thinking/fund-finance-harnessing-nav-finance-new-ways [https://perma.cc/BR6F-Y4ZP].

5 *Understanding the Risks with Net Asset Value (NAV)-Based Lending*, S&P GLOB. MKT. INTEL. (May 5, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/blog/understanding-the-risks-with-net-asset-value-nav-based-lending [https://perma.cc/J4G4-YYRV].

6 Colin Kennedy, *Utilizing NAV Facilities to Back-lever Acquisition Finance*, REED SMITH (Apr. 7, 2023), https://viewpoints.reedsmith.com/post/102icks/utilizing-nav-facilities-to-back-lever-acquisition-finance [https://perma.cc/2DQU-2EKE].

7 Tom Falkus, Kerrick Seay & Sherri Snelson, *The Fund Finance Market Takes Flight*, WHITE & CASE INSIGHT (Aug. 11, 2022), https://www.whitecase.com/insight-our-thinking/us-levfin-2022-the-fund-finance-market-takes-flight [https://perma.cc/52SB-76V4].

8 *See, e.g.*, James F. Albertus & Matthew Denes, Private Equity Fund Debt: Agency Costs and Cash Flow Management 1 (Nov. 11, 2022) (unpublished manuscript) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3410076 [https://perma.cc/7RJD-ARYK] (noting the increasing use of "debt financing at the fund level"). *See generally* Kevin Lynch & Ian Dillon, *Structures, Security and Finance Products: The Increasingly Sophisticated World of Investment Fund Focused Borrowing*, 1 JIBFL 46 (2021). Note that they are referring to investment funds generally, not just to private equity. Steven M. Davidoff has suggested that changes in credit markets can lead to changes in the structure of private equity markets. *See* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 489, 532 (2009). Elisabeth de Fontenay has discussed bank capital calls by funds and argued that private equity funds are increasingly relying on a "scattershot of tactics to boost returns" rather than governance improvements. *See* Elisabeth de Fontenay, *Private Equity's Governance Advantage: A Requiem*, 99 B.U. L. REV. 1095, 1122 (2019).

elevated.[9] For funds caught in this crunch, it offered a welcome solution. Pandemic-related financial market strains have now subsided, yet others have arisen.[10] Hence, exiting investments continues to be challenging and the increasing popularity of NAV financing persists.[11] The use of NAV financing by private equity funds is undoubtedly growing,[12] though some suggest that it remains unclear whether this popularity will be sustained in the long-term.[13] And the variety of borrowers and lenders in this market is expanding.[14]

This Essay explores the rise of NAV financing in the private equity market to provide an overview of this relatively nascent developing area and to highlight the growing phenomenon of debt use at the fund level. It examines potential advantages and disadvantages of NAV financing and valuation challenges that are likely to be associated with the collateral at the heart of this market—a fund's portfolio companies (investments). It also suggests potential challenges to this market, including hidden leverage,[15]

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9 Snelson, *supra* note 4.

10 In 2022, central banks around the world began raising interest rates (monetary tightening), creating tougher financing conditions for many markets, including the private equity market. *See* DECHERT, GLOBAL PRIVATE EQUITY OUTLOOK 4-5 (2023), https://www.dechert.com/content/dam/dechert%20files/knowledge/publication/2022/11/2023-Global-Private-Equity-Outlook.pdf [https://perma.cc/KZ4V-SSJK] (discussing the impact of interest rate increases on credit market conditions). Private equity had a record year in 2021 ($697 billion raised) but raised much less ($537 billion) in 2022. Tabby Kinder & Kay Wiggins, *Carlyle to Miss Deadline for $22bn Fund as Investors Cool on Private Equity*, FIN. TIMES (Dec. 14, 2022), https://www.ft.com/content/c0293844-548b-442f-aa66-711673b3230f [https://perma.cc/7P9A-WCVL].

11 *See* Richard Summerfield, *Huge and Growing: The Rise of NAV Financing*, FINANCIER WORLDWIDE (Aug. 2023), https://www.financierworldwide.com/huge-and-growing-the-rise-of-nav-financing [https://perma.cc/865X-3FHN] (highlighting the growing use of NAV-financing).

12 *See* Brian Foster & Patrick Calves, *NAV Finance Market Update*, CADWALADER (Jan. 7, 2022), https://www.cadwalader.com/fund-finance-friday/index.php?eid=1273&nid=168 [https://perma.cc/J2UL-9YZJ]; *see also* Dechert, *supra* note 10, at 23 (showing that of surveyed senior-level private equity executives around the world, 38% indicated increased "use of subscription/NAV financing" over the past three years).

13 *See* Markdale, *NAV Loans: Double Edged Sword*, MARKDALE FIN. MGMT, https://markdalefinancialmanagement.com/nav-loans-double-edged-sword/ [https://perma.cc/5268-HEE4] ("NAV loan financing is risky. The inherent costs, which can include high interest rates, can weigh heavily on the borrower. Coupled with the potential devaluation of leveraged private equity assets, this could pose substantial layered risks . . . .").

14 Foster & Calves, *supra* note 12; *see also* Jeff Berman & Steven Starr, *Net Asset Value Credit Facilities: Key Issues and the Current Market*, SEWARD & KISSEL LLP (Oct. 11, 2023), https://www.sewkis.com/publications/net-asset-value-credit-facilities-key-issues-and-the-current-market/ [https://perma.cc/BX77-69KU] ("Interest in NAV facilities has grown exponentially in recent years.").

15 For example, the Institutional Limited Partners Association Principles recommends better reporting regarding use of fund finance. Tom Falkus, Matthew Griffin & Sherri Snelson, *NAV Finance Gains Traction as Private Equity Seeks Liquidity*, WHITE & CASE (Nov. 19, 2020), https://debtexplorer.whitecase.com/leveraged-finance-commentary/nav-finance-gains-traction-as-

unsettled legal issues,[16] collateral valuation problems, exacerbated agency costs, and intercreditor conflicts. Stakeholders in private equity's developing NAV financing market are sailing in unchartered waters. In conclusion, it suggests that the trend exemplified by the rise of NAV financing—the increasing use of debt at the fund level—heralds an important evolution in private equity market structure that warrants further examination by legal scholars.

I. OVERVIEW OF A PRIVATE EQUITY FUND

This part of the Essay reviews the basic structure of a private equity fund. The private equity landscape is evolving.[17] Nevertheless, a brief, generalized description of a traditional private equity[18] buyout fund, what Elisabeth de Fontenay calls "the classic private equity strategy,"[19] provides helpful background. Some of the largest private equity firms are publicly traded, but most remain privately held.[20] Almost all are now required to register with the Securities Exchange Commission as investment advisors.[21] Private equity firms themselves typically sponsor multiple funds, which are closed-end[22] and generally structured as limited partnerships.[23] A general partner—or a manager entity, which is also usually owned by the private equity firm

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private-equity-seeks-liquidity [https://perma.cc/84CS-NSEA]; *see also* Sujeet Indap, *Financial Engineering to Be Put on Trial in Bankruptcy Courts*, FIN. TIMES (July 11, 2022), https://www.ft.com/content/e07656a5-6103-487c-8d55-42bb1de56dbc [https://perma.cc/Z9BH-HSRZ] ("'There is a lot of hidden leverage in the system,' says Elizabeth Tabas Carson, an attorney at . . . Sidley Austin.").

16 *See* Indap, *supra* note 15 (paraphrasing and partially quoting Elizabeth Tabas Carson that certain private equity financing structures, including NAV financing, are "as yet untested in a down market").

17 *See generally* MEAGAN ANDREWS, JOSH LERNER & SHRINAL SHETH, WORLD ECONOMIC FORUM COMMUNITY PAPER, THE EVOLUTION OF THE PRIVATE EQUITY INDUSTRY: RETURNS, RELATIONSHIPS AND RESPONSIBILITY (Aug. 2022), https://www3.weforum.org/docs/WEF_Private_Equity_Industry_2022.pdf [https://perma.cc/3GVS-4QXR] (addressing the evolution of the private equity market).

18 *Cf.* Jarrod Shobe, *Misaligned Interests in Private Equity*, B.Y.U. L. REV. 1435, 1442 (2016) ("Private equity is an umbrella term that includes various types of funds with different investment strategies, such as real estate funds, debt funds, or venture capital funds that invest in start-up companies.").

19 de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1098.

20 William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1855 (2018).

21 Elisabeth de Fontenay, *Private Equity Firms as Gatekeepers*, 33 REV. BANKING & FIN. L. 115, 180 (2013).

22 Typically, private equity funds are 'closed-end' funds, meaning there is a limited investment period and duration of these funds. For more on differences between "closed-end" and "open-end" funds, see Leah Edelboim & Mary-Carter Stewart, *It's Not Easy Being (Ever)Green*, NAT'L L. REV. (June 16, 2023), https://www.natlawreview.com/article/it-s-not-easy-being-evergreen [https://perma.cc/R2UY-5A56].

23 Shobe, *supra* note 18, at 1442.

(sponsor)—manages the fund and selects its portfolio investments (companies).[24] Traditionally, funds solely owned their portfolio investments,[25] but this practice is changing.[26] The general partner typically also makes a minimal investment in the fund—often merely 1% of the equity.[27] For its efforts, it receives a management fee (generally 2%) and profit or "carried interest" (traditionally 20%) once the fund's returns exceed a certain threshold or "hurdle rate" (typically an 8% internal rate of return (IRR)).[28] Increasingly, however, these long-expected percentages are the subject of negotiation.[29]

In general, funds have several limited partners (investors), including institutions such as banks, hedge funds, pension funds, sovereign wealth funds or asset managers and, theoretically, could even include wealthy individual investors.[30] Limited partners pay management fees, sometimes make an upfront investment and, most importantly, commit to provide capital to the fund in the future as investments are made. Increasingly, limited partners are also making direct investments in the portfolio companies in which the private equity fund invests.[31] Limited partnership agreements delineate the relationship between the general and limited partners.

During its initial years or "investment period" (generally up to year 6), the fund invests in a number of companies known as its "portfolio

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24 *Id*. Shobe notes that managers and general partners are generally under the same ownership and, therefore, uses the terms interchangeably. *Id*. This Essay does likewise, and it also uses limited partner and investor interchangeably.

25 de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1103.

26 *See id.* at 1113 (noting that private equity funds now invest in portfolio companies in which they have less than 100% ownership).

27 Shobe, *supra* note 18, at 1477.

28 Pierre Schillinger, Reiner Braun & Jeroen Cornel, *Distortion or Cash Flow Management? Understanding Credit Facilities in Private Equity Funds* 4-5, 10 (Feb. 18, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3434112 [https://perma.cc/S7L6-7674].

29 *See* de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1118 (noting the "[g]rowing dissatisfaction" among private equity investors with traditional compensation arrangements and more negotiation of alternative arrangements).

30 It is theoretically possible, though not common, for an individual to be an investor in a private equity fund. *See* William A. Birdthistle & M. Todd Henderson, *One Hat Too Many? Investment Desegregation in Private Equity*, 78 U. CHI. L. REV. 45, 50 (2009) ("[W]ealthy individuals rarely, if ever, invest as limited partners in private-equity funds.").

31 *See, e.g.*, ANDREWS, LERNER & SHETH, *supra* note 17, at 11 ("[Limited partners] are now choosing to make either co-investments alongside their GPs or 'solo' investments instead of only investing in their GP's fund structures."); Benitez, Brown & Ramli, *supra* note 3 (noting that investors such as sovereign wealth funds and pension funds are, among other things, asking for "more co-investment opportunities").

companies."[32] These companies become the assets of the fund. The fund's managers are generally external directors on the companies' boards of directors and might also provide it with operational guidance.[33] Each company is a distinct legal entity with its own balance sheet (assets and liabilities), which generally includes a significant amount of debt.[34] Indeed, buyouts are characterized by high levels of debt: "[t]he key characteristic of an LBO is that the target company [portfolio company] is made to borrow against its own assets to buy out existing shareholders."[35] The general partner typically provides valuations of the fund's portfolio assets to investors on a quarterly basis and audited financial statements annually—a process involving a "high level of individual judgement and subjectivity."[36]

In the remaining years of the fund, its general partner manages and then eventually exits the fund's investments. During this time, fund fee structures might transition to reflect its latter life stage. Prior to a fund's termination, the general partner will typically start marketing a follow-on fund(s) to investors old and new.[37] The general partner's prior fund performance, especially the fund's internal rate of return, is likely to play an important role in the success of such marketing efforts.[38] The lifespans of private equity funds vary but have been increasing, with fifteen plus years now being the average.[39] As explained below, private equity's growing use of fund finance, such as NAV financing, has likely facilitated this development.

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32 Tim Jenkinson, Miguel Sousa & Rüdiger Stucke, *How Fair Are the Valuation of Private Equity Funds?* 5-6 (Feb. 27, 2013) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2229547 [https://perma.cc/3QV8-26WF].

33 de Fontenay, *Private Equity Firms as Gatekeepers*, *supra* note 21, at 125-26 (describing the role of private equity firms on the boards of their portfolio companies); *see also* de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1103 (describing differences between private equity and public company board of directors).

34 Magnuson, *supra* note 20, at 1854-57 (describing the general structure of private equity investments).

35 *See* de Fontenay, *Private Equity Firms as Gatekeepers*, *supra* note 21, at 122 (describing LBO transactions).

36 Jenkinson, Sousa & Stucke, *supra* note 32, at 6.

37 *See generally id.*

38 *See, e.g.*, de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1121 ("IRR is the single most commonly-used measure of a fund's performance, making it a crucial component of the private equity firm's marketing.").

39 Thomas Smith, Patrick Dixon & Emad Shahin, *NAV Financings: A Review of the Year*, DEBEVOISE & PLIMPTON (Feb. 1, 2022), https://www.debevoise.com/insights/publications/2022/02/nav-financings-a-review-of-the-year [https://perma.cc/4QPX-RN34] (quoting Emad Shahin, General Counsel of 17Capital).

II. NET ASSET VALUE (NAV) FINANCING

This part introduces NAV financing, including advantages and disadvantages of its use. A discussion of collateral valuation challenges then follows.

A. *A Brief Description of NAV Financing*

The fund finance market provides financing to a variety of fund types, including private equity, private credit, real estate, and others.[40] NAV financing or lending based upon the net asset value of a private equity fund's portfolio assets has been around a while in the fund finance world[41] and is an increasingly popular option in the private equity space.[42] The overall NAV finance market is forecasted to increase from about $100 billion in 2022 to $700 billion by 2030.[43] For example, this soaring trajectory is illustrated by 17Capital's €2.6 billion credit fund created for NAV loans in 2022, called the "largest debut private credit fund raised globally since 2009[,]"[44] and Vista Equity Partner's $1.5 billion NAV loan in 2023.[45]

NAV financing is a relatively recent innovation or evolution in debt use in the private equity space,[46] and its use continues to accelerate.[47] Lifespans of private equity funds in some cases have increased, and as a fund reaches its later years (five to ten plus years), the capital commitments of its limited partners might have been exhausted.[48] Once a fund has tapped out investor capital commitments, its ability to access additional liquidity becomes limited.[49] Indeed, investors are increasingly demanding the return of their

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40 *See generally* Falkus, Seay & Snelson, *supra* note 7.

41 Summerfield, *supra* note 11 (noting use by hedge-funds for over 20 years).

42 Falkus, Griffin & Snelson, *supra* note 15.

43 Falkus, Seay & Snelson, *supra* note 7.

44 *17Capital Announces Closing of €2.6 Billion NAV Lending Fund*, 17CAPITAL (Apr. 20, 2022), https://www.17capital.com/17capital-announces-closing-of-e2-6-billion-2-9-billion-usd-inaugural-nav-lending-fund/ [https://perma.cc/2FYC-4ZV2].

45 Benitez, Brown & Ramli, *supra* note 3.

46 NAV financing has long been used with other types of funds, although its uptake by the private equity market is relatively recent. Tom Spinks, *Infrastructure Funds – Key Features for NAV Facilities*, CADWALADER (June 3, 2022), https://www.cadwalader.com/fund-finance-friday/index.php?nid=191&eid=1454 [https://perma.cc/QZ2K-YST6].

47 DECHERT, *supra* note 10, at 23; *see also* Falkus, Seay & Snelson, *supra* note 7 (expecting the market "to grow seven-fold").

48 *See* Liam Kennedy, *17Capital's Pierre-Antoine de Selancy: Navigating NAV Lending*, IPE MAG. (Nov. 2022), https://www.ipe.com/interviews/17capitals-pierre-antoine-de-selancy-navigating-nav-lending/10063061.article [https://perma.cc/24DW-NVSX].

49 Patricia C. Lynch & Patricia Texeira, *NAV Financing: A Terrific Tool for Savvy Fund Sponsors*, ROPES & GRAY (Oct. 11, 2022), https://www.ropesgray.com/en/newsroom/alerts/2022/october/nav-financing-a-terrific-tool-for-savvy-fund-sponsors [https://perma.cc/4D29-WXUE].

capital prior to committing to follow-on funds.[50] In providing much needed liquidity, NAV financing essentially buys time for funds, ideally enabling them to strategically delay exits from their portfolio investments where helpful.[51]

NAV financing's most attractive feature is likely its flexibility.[52] These debt facilities are individually negotiated, complex, "highly bespoke in nature,"[53] and typically of three to five years in duration.[54] The private equity fund itself (or a special purpose vehicle of the fund[55]) borrows the funds, typically[56] by securing the loan with the net asset value of its portfolio companies (themselves likely to have high debt levels), or by providing the lender with preferred equity in the fund.[57] Of course, the limited partnership agreement must allow for NAV borrowing.[58] The lenders in this market consist of banks and other institutional investors, including insurers. NAV facilities typically have conservative loan to value ratios, for example, around 20% to 30%.[59] Collateral asset valuation is of paramount concern to both lenders and borrowers. Creditors should closely examine the collateral assets at the underwriting stage and require periodic reporting to ensure adherence

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50 Benitez, Brown & Ramli, *supra* note 3.

51 *See* Kennedy, *supra* note 48.

52 *See, e.g.*, Brian Foster & Patrick A. Calves, *NAV Facilities – The Swiss Army Knife of the Fund Finance Market*, NAT'L L. REV. (Sept. 23, 2022), https://www.natlawreview.com/article/nav-facilities-swiss-army-knife-fund-finance-market [https://perma.cc/3HTT-AV53] ("NAV loans can be structured/tailored to address any number of issues.").

53 Lynch & Texeira, *supra* note 49.

54 Anastasia Donde, *NAV Lending Ramps in Popularity, but Questions Remain*, MIDDLE MKT. GROWTH (Dec. 6, 2023), https://middlemarketgrowth.org/nav-lending-lp-capital-portfolio-company/ [https://perma.cc/KAN8-PNSR].

55 *See generally* Leon Stephenson, *NAV, Asset-Backed and Hybrid Funds Finance Facilities*, 7 BUTTERWORTHS J. INT'L BANKING & FIN. L. 407 (2016).

56 Although NAV financing deals are generally secured, some are unsecured. *See* Lynch & Texeira, *supra* note 49, at 1-2 ("Some established fund sponsors with funds investing in certain high-quality asset classes may be able to obtain unsecured NAV financing. However, most NAV financings are secured.").

57 Donde, *supra* note 54.

58 Lynch & Texeira, *supra* note 49, at 2; *cf.* 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/Q5G7-VVUK] (noting that some investors have begun demanding investor approval for such borrowing); Alicia McElhaney, *Allocators Aren't Happy with the NAV Lending Craze*, INSTITUTIONAL INV. (Aug. 22, 2023), https://www.institutionalinvestor.com/article/2c2fvfypmlmyy9k7zj05c/corner-office/allocators-arent-happy-with-the-nav-lending-craze [https://perma.cc/N4E7-G9TY] (noting that historically, the terms of most limited partnership agreements likely formally permitted NAV lending, but that more recent arrangements might place parameters on its use).

59 Falkus, Seay & Snelson, *supra* note 7. LTV to investors' portfolio of funds could be even higher—in the range of 30-50%. McNeely, *Private Equity Investors Face Expensive Choice: 10% Loans to Get Cash*, *supra* note 2.

to debt covenant requirements.[60] As one commentator noted: "valuations are very important for this type of facility and the frequency of conducting the[m] and whether third party valuations will be required can be keenly negotiated."[61] The typical diversification of a loan facility's collateral assets (the portfolio companies) is an additional reason that NAV financing is generally considered a low risk option by lenders,[62] though there are increasing concerns about potential risks for investors.[63]

NAV financing can provide benefits for a host of private equity constituencies, including general partners, investors, and lenders (some of whom look toward the possibility of eventual loan syndication).[64] Its deployment can be offensive or defensive.[65] For creditors, as noted, NAV financing creates profitable, relatively low-risk lending opportunities.[66] Typical uses of NAV financing include facilitating additional strategic investments by a fund,[67] enabling an earlier return of capital to fund investors (enhancing the fund's internal rate of return and distributions to paid-in capital[68]), increasing available financing for the general partner,[69] and creating or facilitating the continuation or restructuring of funds.[70] It can also be used to support a fund's portfolio companies[71] whose credit facilities could be

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60 *See* Ellen Gibson McGinnis & Deborah Low, *NAV Facilities and Hybrid Facilities*, HAYNES BOONE (Aug. 9, 2019), https://www.haynesboone.com/news/publications/mcginnis-and-low-in-lexis-practice-advisor-nav-facilities-and-hybrid-facilities [https://perma.cc/2K4H-KT5F] ("In order to track NAV measurements and financial covenants, the borrower will be required at least on a quarterly basis to deliver a compliance certificate . . . .").

61 Lynch & Dillon, *supra* note 8, at 48.

62 Allison McNeely, *Private Equity Funds Tap Exotic Loans for Liquidity as Deals Ebb*, BLOOMBERG (Nov. 15, 2022), https://www.bloomberg.com/news/articles/2022-11-15/private-equity-funds-tap-exotic-loans-for-liquidity-as-deals-ebb [https://perma.cc/J5TE-JCEL].

63 *See, e.g.*, Markdale, *supra* note 13 ("However, NAV loan financing is risky. The inherent costs, which can include high interest rates, can weigh heavily on the borrower. Coupled with the potential devaluation of leveraged private equity assets, this could pose substantial layered risks that don't show up on everyone's balance sheet.").

64 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/7NYM-CE4Z].

65 Lynch & Texeira, *supra* note 49, at 1.

66 *Cf.* Aaron Whitworth, *Navigating NAV Loans*, LIONPOINT (July 26, 2023), https://lionpointgroup.com/insights/articles/navigating-nav-loans/ [https://perma.cc/S87L-697X] (discussing the benefits and risk of NAV loans).

67 This is the most common reason for NAV financing. *See* McElhaney, *Private Equity's Woes Spur Rise in NAV Loans—and Managers Offering Them*, *supra* note 64 ("The most common use of the loans is to fund smaller acquisitions, without having to ask investors for more capital.").

68 Distributions to paid-in capital (DPI) is an increasingly important fund performance metric. Kerfoot & Joo, *supra* note 2.

69 DECHERT, supra note 10, at 23.

70 Foster & Calves, *supra* note 52.

71 McNeely, *Private Equity Funds Tap Exotic Loans for Liquidity as Deals Ebb*, *supra* note 62.

expiring (enabling reduced debt cost),[72] to meet general partner fund financing commitments,[73] to retain the fund's portfolio assets for a longer period of time,[74] to avoid the use of a continuation fund,[75] and in certain cases, to provide tax benefits.[76] NAV financing can also increase general partners' investment returns by enabling back-levering of portfolio assets (whether as part of their initial equity commitment or later in the fund life cycle).[77] Although less common, investors with liquidity or portfolio rebalancing needs can themselves secure NAV loans as an alternative to entering, likely steeply discounted, sales of their fund interests in the secondaries market.[78]

NAV financing is sometimes compared to margin loans,[79] but unlike such lending, it is not collateralized by assets with a liquid market. Margin loans are loans collateralized by securities in a trading account.[80] Indeed, a benefit of NAV financing is that it "unlock[s] liquidity from certain illiquid assets."[81] Yet margin loans, although secured by assets with a liquid market, have their perils.[82] Hence, it is reasonable to suggest that NAV financing, secured by illiquid assets, are likely to encounter similar risks. Such considerations perhaps explain why some see NAV loans as a risky, short-term strategy.[83]

The additional liquidity provided by NAV financing has potential costs as discussed at greater length in Part III. It increases leverage in the private equity market, which elevates overall financial market risk.[84] If a fund uses NAV financing to acquire a portfolio company—perhaps also for a portion of its equity commitment—this leverage will generally be in addition to the debt assumed by the portfolio company in the buyout transaction itself.[85] So, it can

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72 *See* Summerfield, *supra* note 11 (noting that NAV financing is sometimes used to refinance expiring portfolio company credit facilities).

73 DECHERT, *supra* note 10, at 23.

74 *See* Snelson, *supra* note 4 ("NAV finance has proven especially helpful for managers that want to hold on to prized assets for longer.").

75 *See* McElhaney, *Private Equity's Woes Spur Rise in NAV Loans – And Managers Offering Them*, *supra* note 64 ("A NAV loan is an alternative to launching a continuation fund.").

76 Whitworth, *supra* note 66.

77 Falkus, Seay & Snelson, *supra* note 7; *see also* Kennedy, supra note 6.

78 McNeely, *Private Equity Investors Face Expensive Choice: 10% Loans to Get Cash*, *supra* note 2.

79 Kennedy, *supra* note 6.

80 *See Margin Loans (Regulation U)*, OCC, https://www.occ.treas.gov/topics/supervision-and-examination/credit/commercial-credit/margin-loans.html [https://perma.cc/7ZPX-KYJQ].

81 Berman & Starr, *supra* note 14.

82 *See* Gara & Louch, *supra* note 58 (noting that margin loans "can trigger a collateral call").

83 *Id.*

84 *See* Chris Flood, *Private Equity's Dirty Finance Secret*, FIN. TIMES (July 27, 2017), https://www.ft.com/content/48d107b2-5fed-11e7-91a7-502f7ee26895 [https://perma.cc/P36U-W3JN] (discussing concerns about systemic risk arising from bank participation in subscription line financing to private equity firms).

85 Snelson, *supra* note 4.

constitute "leverage on leverage."[86] This heightened leverage could ultimately impact market incentive structures, escalate the probability of firm distress, and introduce broader financial market stability risks, especially if NAV financing significantly increases interconnections between private equity and the traditional banking system.[87] The extent of these existing interconnections is currently unclear, making it difficult for regulators to understand potential loss scenarios and financial stability implications for the regulated banking system.[88] Banks and alternative lenders are the predominant creditors in this space, though these respective markets are distinct.[89] The lack of transparency in private equity markets makes it challenging to understand the amount of leverage present and the risk it contributes to financial markets.[90] Many legal issues surrounding NAV financing remain unsettled,[91] increasing the overall risk associated with its use. Additionally, the valuation challenges surrounding illiquid collateral—whether it be a complex financial instrument or a private equity portfolio company—carries its own risk.

86 McElhaney, *Allocators Aren't Happy with the NAV Lending Craze*, *supra* note 58 (quoting Andrea Auerbach of Cambridge Associates).

87 Banks are important lenders in the NAV finance market. Therefore, once this market reaches a certain size, it is reasonable to worry about the implications for systemic risk. Banks are also significant providers of subscription line finance, an area in which some have been concerned about systemic risk implications. *See* Flood, *supra* note 84 (discussing concerns about systemic risk arising from bank participation in subscription line financing to private equity firms).

88 Brook Masters, *Sheila Bair: 'I Feel for the Regulators. You're Damned if You Do and You're Damned if You Don't'*, FIN. TIMES (Dec. 15, 2022), https://www.ft.com/content/56d3cd48-0cf7-44aa-9464-356e22b1065e [https://perma.cc/6Y6T-JN4J]; *see also Understanding the Risks with Net Asset Value (NAV)-Based Lending*, SPGLOBAL (May 5, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/blog/understanding-the-risks-with-net-asset-value-nav-based-lending [https://perma.cc/F33D-YM4C] (suggesting that poorly understood levered connections, such as those via NAV loans between private credit markets and banks or other financial institutions, could contribute to overall systemic risk in financial markets).

89 *See* Patricia Teixeira & Anastasia Kaup, *The Inevitable Rise of NAV Financing*, ROPES & GRAY (Sept. 8, 2023), https://www.ropesgray.com/en/insights/podcasts/2023/09/the-inevitable-rise-of-nav-financing [http://perma.cc/XW6V-H6TX] (discussing the difference between bank and alternative NAV lending markets).

90 *See* Masters, *supra* note 88 (addressing the lack of transparency in the shadow banking system and its implications, in an interview with Shelia Bair, former Chair of the Federal Deposit Insurance Company).

91 *See, e.g*, Lynch & Texeira, *supra* 49 (noting the two major legal considerations with NAV financing: collateral package and flexibility).

B. *Collateral Valuation Challenges*

A foreseeable risk of NAV financings is collateral valuation challenges. Valuation of portfolio companies can be challenging.[92] Research has found "that private equity firm disclosures systematically tend to over-state fund performance."[93] Investors often lack extensive information about fund investments;[94] disclosure here would provide a better understanding of an investment's true worth. Indeed, investors have often called for greater transparency and disclosure from funds about their portfolio assets.[95]

Valuations can impact the returns of investors and also the fees that they pay.[96] A number of valuation methods exist, and the actual use of these methods varies.[97] Indeed, "[t]he valuation of private and illiquid assets is as much art as science."[98] And individual investments have been compared to "works of art—each is different."[99] In addition to this subjectivity, valuations are also vulnerable to manipulation. For example, research findings suggest that private equity NAVs are sometimes inflated for marketing purposes.[100] Similarly, it is reasonable to suggest that NAVs might also be inflated for NAV financing related purposes. Additionally, thus far, NAV financings have primarily been used in financial market areas in which the collateral assets had greater liquidity.[101] Even assets with a thinly traded market should be easier to price than assets with no liquid market at all.

The asset-backed lending at the heart of NAV financing is not a new development in financial markets. Although asset-backed lending has had its challenges, it has been around for a long time. As a fund's portfolio assets are at the heart of a NAV financing deal, it is reasonable to expect that many benefits and challenges generally associated with asset-backed financing are likely to appear in this realm as well. A critical negotiation issue is likely to be whether the fund, the lender, or a third-party service provider will be

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92 *See* Summerfield, *supra* note 11 ("[M]any NAV lenders and borrowers are reportedly grappling with how to price the underlying assets in a NAV facility amid current market conditions . . . .").

93 Magnuson, *supra* note 20, at 1901.

94 *See id.* at 1881-84 (detailing how investors often lack pertinent information).

95 *See* Benitez, Brown & Ramli, *supra* note 3 ("Other requests from some SWFs include demands for more disclosures about the underlying assets in portfolios . . . . The investors are asking for more information about their investments than ever before . . . ."); *cf.* JOHN FERRO ET. AL, GRANT THORNTON, PRIVATE EQUITY VALUATIONS: BEST PRACTICES AND PITFALLS at 4 (2015) ("Limited partners also want greater transparency.").

96 FERRO ET. AL, *supra* note 95, at 3.

97 *Id*. at 4.

98 Jenkinson, Sousa & Stucke, *supra* note 32.

99 ANDREWS, LERNER & SHETH, *supra* note 17.

100 Jenkinson, Sousa & Stucke, *supra* note 32, at 3, 12.

101 *See* Smith, Dixon & Shahin, *supra* note 39 ("Historically, NAV facilities were limited to credit, secondaries and infrastructure funds operating with levered strategies.").

responsible for the initial and periodic calculation of the NAV of the portfolio assets.[102]

Collateral valuation has long been a critical and challenging issue in private equity.[103] Collateral—and its valuation—also lies at the heart of most NAV financing deals. Lenders generally extend NAV funds on a secured basis and expect the collateral package to consist of a diversified pool of investments.[104] Indeed, this collateral diversification reduces the risk of this type of lending. "The collateral package may include: (i) distributions and liquidation proceeds from the fund's investments, (ii) the right to receive such amounts, (iii) a pledge of the bank account into which such distributions are required to be paid . . . and, sometimes . . . (iv) a pledge of equity interests in any entity holding (directly or indirectly) the investments."[105]

Collateral valuation issues in private equity NAV financing are likely to be particularly thorny because of the illiquid, bespoke nature of the collateral assets and because of the absence of a publicly available price for the assets.[106] Portfolio companies are generally what is known as "Level 3" assets, meaning they are complex, without a market price, and sparsely traded.[107] In the absence of a market pricing mechanism, the valuation of Level 3 assets relies upon financial models.[108] A plethora of financial valuation models exist.[109]

102 *See* Bryan Robson & William Gwyn, *Developments in Fund Leverage: NAV Financing and Co-Invest Facilities*, SIDLEY AUSTIN (July 31, 2020), https://www.sidley.com/en/insights/publications/2020/07/developments-in-fund-leverage-nav-financing-and-co-invest-facilities [http://perma.cc/4M92-VCQS] (explaining the different options available for which party will calculate the NAV).

103 *See* Peter D. Easton, Stephannie Larocque & Jennifer Sustersic Stevens, *Private Equity Valuation Before and After ASC 820*, J. INV. MGMT. (forthcoming Dec. 2020) (manuscript at 2), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3314992 [http://perma.cc/L6BH-D3BQ] (noting the finding in a 2018 survey that private equity investors saw valuation as the most important issue in the industry).

104 Lynch & Texeira, *supra* note 49, at 2.

105 *Id.*

106 *See* Snelson, *supra* note 4 ("Privately owned assets that serve as security for NAV facilities, however, are usually illiquid and do not have easily identifiable reference securities that can be looked to for daily pricing."); *see also* Whitworth, *supra* note 66 ("One such risk is the difficulty in accurately valuing the underlying portfolio companies, which are often illiquid investments and subject to volatile valuations.").

107 *See* Stephen Ascher, Charles Riely & Andrew Lichtman, *Illiquid Asset Valuation Presents Unique Risks Amid Pandemic*, LAW360 (Feb. 4, 2021), https://www.jenner.com/a/web/q9nSwecUvsprZvxSrVbnGT/4k1Z27/ascher-riely-lichtman-law360-feb-4-2021.pdf [http://perma.cc/Y333-V95F] ("[There] are assets that are so rarely traded and so complex [that] there are no market prices available for them. These assets [are] known as Level 3 assets . . . .").

108 *See id.* ("Level 3 assets . . . must be valued using mathematical models that include subjective assumptions about future events such as the risk of default.").

109 *See* Sylvia Dyke & Lauren Hayes, *Valuation of Level 3 Portfolio Companies: Why Is It So Important, and How Can I Help Make the Audit Process Easier?*, BAKERTILLY (Mar. 30, 2021),

Financial models contain a host of financial and economic assumptions that critically impact the valuations ultimately arrived at by each model.[110] For example, a borrower's forecasts about the future value of portfolio assets are subjective and are impacted by assumptions about economic considerations such as taxes, interest rates, and inflation.[111] Even using public market benchmarking data does not necessarily make valuation straightforward.[112] Hence, there is a foreseeable risk of valuation disputes about the assumptions feeding these models, and disagreements are likely to intensify in stressed markets, where valuation can be expected to be more challenging and defaults are on the rise.[113] Collateral valuation issues are often highly contentious issues in distress or bankruptcy scenarios.[114] Valuation questions in NAV finance are likely to be most important and contentious when they matter the most.

NAV finance undoubtedly "unlock[s] liquidity from certain illiquid assets."[115] In fact, some have suggested expanding NAV lending into other asset classes.[116] Financial market participants have also long struggled with valuing illiquid assets, especially in times of crisis.[117] For example, market uncertainty about the value of mortgage-backed securities played a key role in the 2007-08 financial crisis.[118] Indeed, valuation issues "were at the core of litigation arising out of the 2008 financial crisis."[119] Some commentators have

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https://www.bakertilly.com/insights/valuation-of-level-3-portfolio-companies [http://perma.cc/Q29U-P9NB] (listing various financial valuation models).

110 *But see* Spinks, *supra* note 46 ("[T]he valuations remain subject to a number of operative assumptions relating to economic factors such as interest rates . . . .").

111 *Id.*

112 *See* ANDREWS, LERNER & SHETH, *supra* note 17, at 5 ("Moreover, choosing a proper public market benchmark can be challenging.").

113 *Cf.* Ascher, Riely & Lichtman, *supra* note 107 (noting that market turbulence can increase the difficulty of and disputes involved with valuing illiquid assets).

114 *Id.*

115 Berman & Starr, *supra* note 14.

116 *See* Kerfoot & Joo, *supra* note 2.

117 *See* Ascher, Riely & Lichtman, *supra* note 107 ("Needless to say, in a volatile market, the range of what would potentially be a reasonable assumption is necessarily far broader than in a stable market.")

118 *See* Frederic S. Mishkin, *Over the Cliff: From the Subprime to the Global Financial Crisis*, 25 J. ECON. PERSPS. 49, 50 (2011) (describing the role of pricing uncertainty in the 2008 financial crisis); *see also* Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* 29 (Yale ICF, Working Paper No. 09-14, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1440752 [http://perma.cc/6RN3-EX9V] ("We hypothesize that the market slowly became aware of the risks associated with the subprime market, which then led to doubts about repo collateral and bank solvency.").

119 Ascher, Riely & Lichtman, *supra* note 107.

even made comparisons between NAV financing and the "AAA tranches of subprime CDOs" that proved problematic during the financial crisis.[120]

III. NAV FINANCING AND AGENCY COSTS

The private equity market has long had both its supporters and detractors.[121] Proponents have traditionally pointed to governance efficiencies, especially the closer alignment of management and ownership interests than in the case of public companies, as a key aspect of its success.[122] Yet scholars also have argued that while private equity might ameliorate some agency costs,[123] it can create others.[124] The expanded use of fund finance in the private equity space is likely to catalyze further evolution in market structure. It also risks exacerbating agency costs and intercreditor conflicts. This Part of the Essay explores these possibilities in the context of NAV finance, an increasingly important tool of the private equity funds' debt evolution.

As noted, NAV finance can benefit a fund's limited partners both directly and indirectly. First, it can be used to facilitate an earlier return of investor capital. Second, its use can provide necessary support to portfolio companies and promote a more strategic exit, which should ultimately benefit investors. Third, if a NAV loan facility requires third-party valuation of portfolio company collateral, it can act as a check on a general partner's valuation of a fund's portfolio assets. Such third parties can be an "information intermediar[y]" that better aligns interests of investors and general partners regarding fund valuation.[125] Fourth, it can provide investor liquidity while avoiding potentially discounted sales in the secondaries market.[126] Finally,

120 Ted Seides, *NAV Loans: Canary or the Gold Mine?*, CAPITAL ALLOCATORS at 5 (Oct. 11, 2023), https://www.capitalallocators.com/nav-loans-canary-or-the-gold-mine/ [http://perma.cc/CC2X-KYS8].

121 *See* de Fontenay, *Private Equity Firms as Gatekeepers*, *supra* note 21, at 125-33 (reviewing common arguments for and against private equity and also arguing that private equity provides a debt market gatekeeping function); *see also* Magnuson *supra* note 20, at 1847-52 (reviewing perspectives of the supporters and the detractors of private equity).

122 *See* de Fontenay, *Private Equity Firms as Gatekeepers*, *supra* note 21, at 130-32 ("Private equity minimizes the severe agency costs that exist with public company management as a result of the separation of ownership (by dispersed shareholders) and control (by hired management).").

123 *See* Magnuson, *supra* note 20, at 1848, 1857-64 (noting that "conventional wisdom" regarding private equity is that it ameliorates the problem of firm separation of ownership and control).

124 *Cf. id.* at 1892 (analyzing sources of private equity governance costs); Shobe, *supra* note 18, at 1477-78 (analyzing compensation-related agency costs in private equity).

125 *See* Magnuson, *supra* note 20, at 1909 (discussing the potential for information intermediaries to ameliorate governance issues within private equity).

126 *See* Whitworth, *supra* note 66 ("NAV loans . . . are often a much faster method of freeing up cash than the alternative secondary transaction and the LP does not have to take a discount on the investment.").

with sufficient growth of the NAV loan market, a securitized market for these assets could be developed, expanding investment opportunities for more investors.[127]

However, without sufficient transparency and disclosure by fund managers of their NAV finance use,[128] this flexible liquidity could exacerbate agency costs between general and limited partners. For example, NAV finance could fund part of a general partner's equity commitment,[129] a generally minimal requirement that nevertheless purportedly aims to strengthen the alignment of interests between general partners and investors. Such use of debt could decrease the effectiveness of this minimal incentive structure alignment and introduce well-known tensions between debt and equity holders. NAV financing could provide an incentive to aggressively value a fund's assets to secure additional liquidity. The liquidity provided by NAV loans could also be used to delay exit from poor investments, ensuring the continued payment of related management fees.[130] "Zombie funds," or delayed exit from portfolio investments, have at times been an issue in the private equity space.[131]

Moreover, NAV financing and what is known as *subscription line financing* share important similarities. Both types of facilities—hybrid facilities exist[132] —are fund-level debt and are increasingly being used to provide private equity funds with additional liquidity, though typically at different periods in a fund's lifespan.[133] Subscription line financing and NAV financing are essentially "mirror image[s]" of each other.[134] Like NAV financing, subscription line financing can provide additional liquidity to a private equity fund.[135] However, it is secured by the outstanding capital commitments of a fund's limited partners.[136] Subscription line financing can bridge the gap between the time general partners/managers make a portfolio investment and

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127 *See* Smith, Dixon & Shahin, *supra* note 39, at 2 (noting how NAV facilities have expanded from middle-market sponsors to more high market sponsors that are now more willing to utilize NAV financing).

128 Note that LP investors have sometimes been surprised by the GP's use of NAV financing. *See, e.g.*, McElhaney, *supra* note 58 (describing situations where investors are taken aback by NAV investing decisions by their general partners).

129 *See generally* Robson & Gwyn, *supra* note 102 ("[A] [c]o-invest facilit[y] [is] . . . structured as a loan to that person [a co-investor] to finance its capital commitment to the fund.").

130 *See* Shobe, *supra* note 18, at 1474 (arguing that certain management fee terms could incentivize managers to delay exit from poorly performing investments).

131 Magnuson, *supra* note 20, at 1879.

132 *See* Lynch & Dillon, *supra* note 8, at 49 (noting the emergence of hybrid facilities that have features of both a capital call and a NAV facility).

133 *See* Stephenson, *supra* note 55 (noting an uptick in subscription line and NAV lending).

134 Robson & Gwyn, *supra* note 102.

135 Lynch & Dillon, *supra* note 8, at 48.

136 *Id.*

the actual time required for the drawdown of limited partners' capital commitments in practice, or even delay the drawdown of such capital.[137] It can also promote investor cash flow management by acting as interim liquidity between scheduled, periodic payments of capital commitments.[138] Both types of debt can be used "to finance the payment of the fund's costs and expenses."[139]

However, some research suggests that the use of subscription line financing can increase agency costs in the private equity market.[140] Academics and others have noted that subscription lines of credit can be used for questionable financial engineering.[141] For example, the liquidity they provide can facilitate delays in investor capital calls "in a way that may give a misleading view of fund performance."[142] The use of investor funds for a shorter period increases the fund's internal rate of return, a key performance metric.[143] The significant potential for manipulation can be seen by the fact that, in theory, a fund could make an investor capital call one day before the divestment of an investment.[144] Indeed, in 2017, the Institutional Limited Partners Association published *Subscription Lines of Credit and Alignment of Interests: Considerations and Best Practices for Limited and General Partners* to address concerns in this area and suggest improved practices.[145] A fund's internal rate of return is a key data point for current investors, for potential investors in a manager's follow-on funds, and for a manager's compensation.[146] In sum, subscription line finance can provide helpful

137 *See* de Fontenay, *Private Equity's Governance Advantage: A Requiem, supra* note 8, at 1121 ("[F]unds are now borrowing under [capital call] facilities for months at a time, funding even large investments without their own investors' capital.").

138 *See* Flood, *supra* note 84 ("[M]any institutional investors support the use of subscription-line financing as a tool to help them manage cash flows.").

139 Robson & Gwyn, *supra* note 102.

140 *See* ANDREWS, LERNER & SHETH, *supra* note 17, at 10 (highlighting academic research on subscription line financing and agency costs).

141 *See id.*; Schillinger, Braun & Cornel, *supra* note 28, at 16 (finding that extensive use of subscription facilities can increase fund performance measures and rankings); Albertus & Denes, *supra* note 8, at 2-3 (finding that funds use debt to increase performance metrics).

142 ANDREWS, LERNER & SHETH, *supra* note 17, at 10 (see Box 1).

143 *See id.* ("Delaying the arrival of LP capital reduces the time it is deployed, increasing the internal rate of return . . . .").

144 ANDREWS, LERNER & SHETH, *supra* note 17, at 10 (see Box 1).

145 INSTITUTIONAL LTD. PARTNERS ASS'N, SUBSCRIPTION LINES OF CREDIT AND ALIGNMENT OF INTERESTS: CONSIDERATIONS AND BEST PRACTICES FOR LIMITED AND GENERAL PARTNERS (June 2017), https://ilpa.org/wp-content/uploads/2020/06/ILPA-Subscription-Lines-of-Credit-and-Alignment-of-Interests-June-2017.pdf [http://perma.cc/54VK-7EUL].

146 *Cf.* de Fontenay, *Private Equity's Governance Advantage: A Requiem, supra* note 8, at 1121 (summarizing the importance of the internal rate of return in measuring a fund's performance).

additional liquidity to funds, but it can also facilitate engineered fund performance improvements, rather than actual performance improvements.[147]

Furthermore, such questionably enhanced performance metrics might also benefit some limited partners' compensation if components are tied to an investment's internal rate of return.[148] And if the investor is investing other's money, for example in the case of a public pension fund, subscription line financing could also exacerbate agency costs in this relationship.[149] To minimize the potential for increased agency costs surrounding subscription line financing, enhanced disclosure of loan details, loan-related fee responsibilities, and the impact on fund performance would be beneficial.[150]

Once a fund has exhausted its investor capital commitments, the availability of subscription line finance disappears.[151] It is then that NAV finance might be harnessed, although, as noted, hybrid facilities combining both types of fund debt exist.[152] Similar to subscription line loans, NAV loans have benefits and costs for investors, a consideration likely to be impacted by whether its use is offensive or defensive. For example, it is foreseeable that NAV financing could also be used to enhance fund performance metrics, thereby exacerbating agency costs. As it can facilitate an earlier return of investor capital, NAV financing can impact the internal rate of return measures—the inverse of using fund finance to delay investor capital calls to enhance this performance metric.[153] Indeed, some investors' wariness about NAV financing stems from concerns that its use is more about deploying financial engineering to juice returns,[154] and that such financing largely

147 *See* Flood, *supra* note 84 (citing concerns by private equity heads on how fund returns differ based on use of subscription line financing).

148 *Id.*

149 *See id.* (noting that some public pension fund managers might receive a performance bonus based on a fund's internal rate of return).

150 *See* Flood, *supra* note 84 (proposing use of disclosure and reporting requirements for investors to better understand the impact of subscription lines on a fund's performance).

151 *See generally* Lynch & Dillon, *supra* note 8.

152 Stephenson, *supra* note 55, at 407 (discussing the existence of hybrid facilities).

153 For the first few years of a traditional private equity fund, returns are generally negative as costs exist and fees are paid, but portfolio investments are in process. Fund returns in this early period are generally characterized by what is referred to as the "J-curve." *See* CAIS, *An Introduction to Private Equity Secondaries*, CAIS GRP. (Sept. 7, 2022), https://www.caisgroup.com/articles/an-introduction-to-private-equity-secondaries [http://perma.cc/SG75-Q4SN] (highlighting the typical trend of a J-curve, consistent with a period of negative returns in the first years of a PE fund's lifecycle).

154 *See* Gara & Louch, *supra* note 58 (citing concerns from investors on the use of net asset value financing as financial engineering rather than as a reflection of underlying performance); *see also* Seides, *supra* note 120 (noting that NAV loans could be used to boost returns artificially); Donde, *supra* note 54 ("The LP [limited partner/investor] community is split on the benefits or pitfalls of the strategy . . . .").

provides "oxygen tank[s] for GPs [fund general partners]" in a difficult exit environment.[155]

Concerns already exist about disparate treatment of fund investors.[156] NAV financing could exacerbate this worry if an early return of capital were only for select investors or largely benefited certain investors. For example, certain investors might be against a NAV financing deal welcomed by the majority of investors.[157] Investor returns should be tied to the ultimate actual success of a fund's investments. With the possibility of a return of capital prior to divestment of an investment asset (for example, if the general partner creates a continuation fund), investors risk additional conflicts of interest.[158] An investor's exit ability is often seen as a managerial disciplining device.[159] For example, William Birdthistle and Todd Henderson suggested that the growth of the then nascent private equity secondaries market could provide investor exit opportunities that would discipline managers and "ameliorat[e] conflicts of interest."[160] Additionally, they suggested it could promote better pricing of investments and incentivize managers to act in investors' best interest.[161] Birdthistle and Henderson concluded from interviews with general partners that they were "cool to the development of a secondary market" and that their "attitude . . . appear[ed] to be that [the] market does not convey a benefit to them, only administrative costs and potential liabilities from unvetted investors."[162]

Today, ironically, general partners lead about half of the deals in the $130 billion per year private equity secondaries market.[163] NAV financing is an important tool facilitating the private equity secondaries market,[164] which

155 Seides, *supra* note 120 (quoting Ana Marshall, CIO of the Hewlett Foundation).

156 *See, e.g.*, Magnuson, *supra* note 20, at 1884-89 (discussing the differential treatment of investors by private equity funds).

157 *See* Benitez, Brown & Ramli, *supra* note 3 (discussing instances of minority groups blocking NAV financing).

158 *See* Hugh MacArthur & Brenda Rainey, *Shifting Gears: Private Equity Report Midyear 2022*, BAIN & CO. (July 18, 2022), https://www.bain.com/insights/shifting-gears-private-equity-report-midyear-2022/ [https://perma.cc/K7Y9-MJNQ] (noting the criticism that most general partner-led deals overly benefit general partners).

159 *See* Birdthistle & Henderson, *supra* note 30, at 54.

160 *Id.* at 49.

161 *Id.* at 54.

162 *Id.* at 75.

163 *See* CAIS, *supra* note 153 (noting how GP-led continuation vehicles are significant players in the secondaries market); Andrew Snyder, Linge Sun & Nicholas Reade, *The Evolution of the Private Equity Secondary Market*, CAIS GRP. (Sept. 7, 2022), https://www.caisgroup.com/articles/the-evolution-of-the-private-equity-secondary-market [https://perma.cc/LQ6V-F9VR] (noting how GP-led transactions have become common in the secondary market).

164 *See, e.g.*, Olivier Berment, *NAV Finance Expands Ardian's Role in the Secondary Market*, ARDIAN (Nov. 15, 2023), https://www.ardian.com/news-insights/article/nav-financing-expands-ardians-role-secondary-market [https://perma.cc/TWN4-M4KW] ("The secondary market for

increasingly provides general partners with an additional "liquidity tool."[165] Limited partners are increasingly exiting their fund interests via the private equity secondaries market.[166] Yet the current trajectory of the secondaries market—with more than half of the deals being general partner-led transactions where general partners are on both sides of the transaction[167]—is creating important conflicts of interest[168] and controversy.[169] Indeed, the SEC recently implemented a final rule, currently being challenged by certain players in the private equity industry, that would require enhanced disclosures in general partner-led secondary transactions.[170]

Other scholars have argued that investors' ability to exit can "create a complicated and varied set of incentives for managers that do not always help to reduce agency costs,"[171] and that "exit is a controversial mechanism."[172] Indeed, some "have argued that greater liquidity actually impairs corporate governance,"[173] and that governance outcomes are likely to be impacted by an exit's terms.[174] Is NAV finance an example of a "new money-making strateg[y] . . . introduc[ing] conflicts of interest and complexities that alter private equity's role in corporate governance[?]"[175] The use of fund finance in private equity, such as NAV and subscription line loans, offers a nuanced perspective on the agency costs of debt, an idea which usually refers to

private equity and infrastructure funds is growing quickly and already represents an opportunity worth tens of billions of dollars a year.").

165 Snyder, Sun & Reade, *supra* note 163.

166 *See* ANDREWS, LERNER & SHETH, *supra* note 17, at 11 (discussing how shifting relationships between limited and general partners led to limited partners selling fund holdings in the secondary market).

167 *See generally* Fadi Samman, Krishna Skandakumar & Amanda Butler-Jones, *Countdown to Launch: Top 10 Considerations in GP-led Secondary Deals*, REUTERS (Mar. 2, 2022), https://www.reuters.com/legal/legalindustry/countdown-launch-top-10-considerations-gp-led-secondary-deals-2022-03-02/ [https://perma.cc/9VVK-RF4B] ("GP-led secondary deals require careful consideration of conflicts of interest in light of the sponsor's role on both the buy and sell side.").

168 *See generally id.*

169 *See* Kaye Wiggins, *Selling to Yourself: The Private Equity Groups that Buy the Companies They Own*, FIN. TIMES (June 21, 2022), https://www.ft.com/content/11549c33-b97d-468b-8990-e6fd64294f85 [https://perma.cc/4J3E-6P2Y] (noting that it can be challenging for limited investors in an initial fund to assess the true benefit of a deal).

170 *See* David M. Ruff et. al, *Continuation Funds: A Continuing* Trend, ORRICK (Sept. 28, 2023), https://www.orrick.com/en/Insights/2023/09/Continuation-Funds—A-Continuing-Trend [https://perma.cc/N6UW-ZGJ6] (describing the regulatory landscape around GP-led secondary transactions).

171 Shobe, *supra* note 18, at 1484.

172 Magnuson, *supra* note 20, at 1880.

173 *Id.*

174 *See id.* ("[G]reater exit rights reduce the incentive for investors to play a constructive role in the governance of those investments.").

175 de Fontenay, *Private Equity's Governance Advantage: A Requiem*, *supra* note 8, at 1101.

incentive misalignments between borrower and lender.[176] In this context, the agency costs of debt also appear to encompass the relationship between general and limited partners. In sum, as characteristically flexible NAV finance facilities can be used to facilitate investor exit, it is important to consider how growth in the use of fund finance in the private equity market could exacerbate agency costs and other conflicts.

Finally, it seems reasonable to speculate that both NAV and subscription line financing could increase intercreditor conflicts, which are already on the rise in the private equity space.[177] For example, NAV lenders generally have a security interest in the fund holding the portfolio companies, and should be subordinate to lenders with a direct security interest in the underlying portfolio companies.[178] However, various creditor conflicts could arise from the use of NAV facilities.[179] And managers have a history of providing preferential treatment to creditors or investors able and willing to provide fresh capital to a firm upon its distress.[180] Hence, given market and contractual complexities, it remains to be seen how various fund finance facilities might interact with other private equity debt facilities in distressed scenarios, especially if their market uptake is recent, as is the case with NAV financing in the private equity space. As many issues surrounding NAV financing remain uncertain, many questions in this area have also not been answered. For example, could a NAV lender use contractual ambiguities or the market's nascent stage to enhance their security position vis-à-vis supposedly senior creditors in a distress scenario?[181] Were a fund to use NAV lending to support a portfolio company's operations, could the provision of

176 *See* de Fontenay, *Private Equity Firms as Gatekeepers*, *supra* note 21, at 148, 161 (discussing the agency costs of debt, such as "adverse selection and moral hazard").

177 See generally the *University of Pennsylvania Law Review*'s 2022 Symposium on *Debt Market Complexity: Shadowed Practices and Financial Injustice*, in which the topic of intercreditor conflicts arose on several panels. *Debt Market Complexity: Shadowed Practices and Financial Injustice*, U. PA. L. REV., https://www.pennlawreview.com/symposium/ [https://perma.cc/ZJ2T-HGPZ].

178 *See* Stephenson, *supra* note 55, at 407 (describing the ordering of lenders providing finance through secondary funds versus other lenders).

179 *Cf.* Brian Foster & Patrick Calves, *Assessing 'Bad Acts' Risk in NAV Facilities*, CADWALADER (May 20, 2022), https://www.cadwalader.com/fund-finance-friday/index.php?eid=1443&nid=189 [https://perma.cc/U9BU-UXGQ] (defining 'bad acts,' partially, as an investment "becoming subject to the claims of other creditors").

180 *See* Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1559, 1573–74 (2022) (noting how the culture around reorganization is to favor managers and new creditors versus existing creditors).

181 For example, given the flexibility of some private market lending contracts, it is foreseeable that a later creditor could use such terms to their advantage. *See* Laura Benitez & Silas Brown, *Pimco Squares Up for a Bareknuckle Fight in Private Credit*, BLOOMBERG (Jan. 30, 2024), https://www.bloomberg.com/news/articles/2024-01-31/private-credit-pimco-prepares-for-when-the-bubble-bursts [https://perma.cc/QL9U-WNY7] (noting the "wiggle room" in some private credit contracts).

such financing be used to enhance a NAV lender's security interest should the investment become distressed? As NAV financing can be used in the acquisition of portfolio companies—for example, as part of the general partner's equity commitment—and at later stages in a fund's lifespan,[182] how might it impact intercreditor relationships in distress scenarios?

CONCLUSION

While many such questions remain unanswered, it is abundantly clear that the private equity markets' use of debt at the fund level is increasing. The growing NAV finance market exemplifies this trend. Along with subscription line financing, NAV financing signals a further evolution in the use of debt in the private equity space. This Essay not only highlights this development but also suggests that it is likely to have important ramifications, such as increased agency costs and intercreditor conflicts that are ripe for additional research by legal scholars.

182 *See* Falkus, Seay & Snelson, *supra* note 7 (discussing the use of NAV financing "as [either] part of the original acquisition financing or on a post-deal basis").